



Challenge

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letters TO THE EDITOR

Challenge invites your comments. Address letters to
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The unsolved problem

•“The Dealer’s Dilemma” [CHALLENGE, January 1957] was an excellent article and I enjoyed it very much. You have done a good service in publishing it.

All good wishes.

JAMES ROOSEVELT

Washington, D. C.

Rep. Roosevelt (D-Cal.) was chairman of the subcommittee of the Select Committee on Small Business which investigated the problems of small businessmen in the petroleum industry.—Ed.

•I and my organization, the National Federation of Independent Business, have been cognizant of the situation presented in your article, “The Dealer’s Dilemma” [January 1957], since 1941 when another committee, the Senate Small Business Committee, examined the relations of major rubber and oil companies with independent filling stations.

Both the Federal Trade Commission and the Department of Justice were informed of this situation at that time, and here, some 16 years later, the problem is far from being solved. Congress must take positive action to bring real free enterprise into the filling station field by adopt-

ing legislation that would divorce or prohibit petroleum companies from owning and operating filling stations.

GEORGE J. BURGER

Washington, D. C.

Debatable inflationary points

•I was particularly interested in your December issue, not so much because I agreed with some of the views expressed, but rather because of the salient points brought under discussion.

John McKnight’s article, “Inflation’s New Threat,” can be praised for its quick review of debatable points in our present money and price situation.

As others have stated it, the economy has grown up to its money supply. Hence, as Mr. McKnight says, “the current ‘money shortage.’”

I think he is wrong, though, in attributing this tightness to the actions of the Federal Reserve Board. They had no choice except to ration a severe money shortage already in existence. There is a limit to the volume of supported activities which can be financed by taxes and credit issues based on the self-supporting sector of the nation’s occupational structure.

I enclose a check for two-year re-

newal of your excellent publication. The coming year will, no doubt, provide plenty of economic grist to keep it well supplied with articles.

WAGER FISHER

Bryn Mawr, Pa.

Growth of the arts

•George Seldes' eminently readable article about the nature of the entertainment we may expect in 1975 [CHALLENGE, January 1957] implied, but did not develop, an important aspect of the growth of the arts that appears on the horizon.

He refers to "the rise in the educational and cultural levels which will probably take place" in the population by 1975. The rise is apparent today, and it has led to ever-increasing appeals upon our government to create a National Academy of the Arts.

Such an academy could coordinate the activities of individuals, companies and organizations interested in, or working toward, the development of the arts—in the theater, in literature, painting and music. It could aid in improving the quality of television shows and motion pictures, as well as increasing the quantity of cultural activities throughout the nation.

MICHAEL CHAMBERS

Phoenix, Ariz.

They like us

•You have an exceptionally and consistently sound and thought-provoking economics magazine.

RICHARD T. GRAHAM

New York, N. Y.

•Your magazine is not only good to look at, but good to read.

JAMES BURLIN

Chicago, Ill.

•I certainly enjoy your concise and informative magazine.

R. T. RABNER

Bethesda, Md.

•Your fresh approach to economics is a far cry from the way I learned my basic knowledge of the subject 25 years ago. Keep up the good work!

NORBERT H. SCHMIDT

Grandville, Mich.

•I have never, in all my life, read a more enjoyable magazine than CHALLENGE. I look forward to the next magazine each month. Enclosed is my remittance for another year's subscription.

A. W. BIEKER

Kansas City, Mo.

Reader Lamp dissents

•Sorry, but I am unable to share your view that CHALLENGE is a good magazine.

When one reads a large city paper, one is already absorbing 90 per cent of CHALLENGE. The articles in your magazine must not duplicate, in a digest-of-a-digest form, information which is readily available from daily sources.

Articles which have value for me [all in CHALLENGE, January 1957] are: "Are We Headed for More Inflation?" (but extended to three times the scope); "Bargaining from Strength and Weakness"; and "The Basis of Soviet Justice."

However, I for one cannot understand how a magazine purportedly specializing in one field becomes so all-embracing, so that each article is, therefore, shorn of thoroughness by lack of space.

ROBERT LAMP

Sayville, N. Y.

a personal note

from the editor

*some random thoughts that
tax Americans today*

IT WAS A recklessly brave man, I think, who once observed that taxes must be of the female sex because they are so hard to live with, yet so necessary. Or was it a woman who said all taxes are male? Well, whichever way it was, any difference of opinion here revolves around an academic point; the word "taxes" in the English language has no gender. But there are some other facts about taxes worthy of consideration.

In 1929 taxes collected by all levels of government represented 10.7 per cent of the nation's net national product. By 1955 the total tax bill came to 27.1 per cent of the net national product. This means that taxes, relative to our net product, have been increasing on an annual average of six-tenths of one per cent since 1929. At this rate, by 1975 our total tax bill should amount to almost 40 per cent of our net national product.

In 1902 the federal government's tax bill came to 517 million dollars; the state and local governments' to 860 millions. By 1956 the federal government was collecting 72.16 billion dollars in taxes; while the state and local governments were taking in 27.64 billions. Again, by using the simple formula of average increase per year, we come up with the interpolation that by 1975 the federal government will be collecting 97.42 billion dollars; while the state and local governments will be living on 37 billion dollars.

But this isn't the whole story. In 1902 the federal government collected 37.5 per cent of all tax receipts; the state governments 11.3 per cent; and local governments 51.1 per cent. By 1956 the federal government was collecting 72.3 per cent of all taxes; the state governments, 14.7 per cent; and local governments, 13 per cent. Once again, if we average out the rates of increase or decrease, we find that by 1975 the federal government will be collecting 84.5 per cent of all taxes; the state governments, 15.5 per cent; and the local governments, *nothing*. Therefore, of the 37 billion dollars that state and local governments

were supposed to be collecting in 1975, only 21 billion dollars will be realized—and this only by the states—because technically the local governments will no longer be in the tax-collecting business. The federal government will pick up the remaining 16 billions, thus raising its total tax take to 113.5 billions by 1975.

Admittedly, it is a dangerous game to make projections on the basis of average annual increases or decreases. Presumably, trends can be reversed, knocking into a cocked hat all such notions as, for example, that the local governments will be collecting no taxes by 1975. On the other hand, our interpolations are based on trends established during the course of 25 years, or more, and it is just possible that such trends will go on to a ridiculous conclusion.

Here are some random thoughts suggested by these facts. If they paint an Orwellian picture of the future, let me hasten to add that I am a firm believer in the adage that people get the kind of government they deserve. And I single out government as the chief subject of our discussion here because although we are ostensibly talking about taxes, the implication of the figures on taxes is that the more centralized bodies of government are taking more and more of the taxes collected, and that taxes are totaling to an ever-increasing percentage of our net national product.

The conclusions to be drawn are inescapable, but not always obvious. The activities of our various levels of government are contributing, to a constantly increasing degree, to the process of our national economic activity. This means that government is becoming a more formidable agency for capital formation. This, in turn, means that private, individual initiative is contributing less, with each decade, to the process of capital formation from which emerges the product of our economy.

But not only is individual resource giving ground before government resources; the most significant fact of all is that the one area of government, local government, to which the individual citizen has the quickest access has all but become effete as a tax-collecting agency.

Perhaps this is as it should be. Perhaps there is a good reason why decades of crises should thrust the federal government to the fore. If it must be this way, then it seems to me that a great deal of our current discussion about taxation is not relevant to the reality of the times. On the other hand, if there can be another way, then it seems to me that there is no time like the present to start thinking about an alternative. By 1975 it may be too late.—H.B.



Challenge Notes

Cutting the budget: the economic and the necessary

FOR THE democracies of the world the annual budget message is generally the top political event of the year. In a sense, it is even more important (though certainly less dramatic) than an election, for it spells out in the greatest detail what the administration plans to spend money on. And in the kind of society we have, where almost every effective policy costs money, a budget is just about the best clue there is to the intentions of government.

The budget also presents Congress with its most important check on the administration. Unlike many European governments which can be overturned by a simple vote of no confidence, Congress cannot turn our President out of office, except by impeachment. Through its constitutional power to appropriate money, however, Congress can virtually scuttle administration policies. But it must be willing to go on record as opposing that policy—or at least, the expense of that policy.

In the complicated and dangerous world we live in, this is not easy. Take President Eisenhower's record 72-billion-dollar budget. Everybody, including the administration, agrees that this is "too high." From a strictly economic point of view, there can be no question that, coming at a time when the cost of money is already high, the budget will tend to be inflationary even though it is balanced.

The budget, however, is primarily a political, not an economic document. The difficulty with using budget and tax policy primarily as a means of encouraging economic growth and stability (*see page 13*) is that this does not take into account the desires and needs of people which are often "uneconomic" though deemed necessary. Obviously a government budget in which 63 per cent of federal revenues is slated for defense cannot claim to be economical. Military expenditures are, from a strictly economic point of

view, the most useless expenditures there are. Yet without these expenditures national survival, economic and otherwise, is impossible. Neither Congress nor the people whom it represents wants to sacrifice national security for the sake of economy. If anything, chances are that the President will get more, not less, defense money than he asked for.

Where else can cuts be made? Well, 24 per cent of the budget goes for "civil benefits" (conservation, the farm program, urban renewal programs, health services, etc.). Again, many of these benefits are "uneconomic"—and all of them are expensive. But they are the kind of benefits the majority of Americans want, and must, therefore, pay for. A President or a Congress that would *seriously* cut into these benefits would not long remain in power.

Of the remaining 13 per cent, 10 per cent goes into paying for the interest on the national debt and three per cent goes into administration. Nothing much can be done about the interest charges on the debt. The debt itself has been the result of meeting the emergency needs of war and depression when our national survival was at stake. The way to avoid increases in the size of the debt is to avoid the emergencies that, in the past, have given rise to it. As for the interest on the debt,

in a time of "tight money," government, like everybody else, must compete for scarce funds, and interest on its securities is bound to rise.

That leaves us with the three per cent of the budget that goes into administration. It is on this three per cent that Congressional axe wielders will concentrate. No doubt there is room for improvement here—even the administration admits that. But making all due allowance for the tendency of all bureaucracies to protect their jobs, we doubt that sizable cuts can be made without adversely affecting the efficiency of government.

This does not mean that Congress should be complacent and accept without question every money request the administration makes. Nor does it mean that high budgets are desirable. It does mean, however, that a budget reflects needs and desires which, although uneconomic, are (or are thought to be) necessary.

Impressing the neighbors

MADISON AVENUE has alerted us to a significant change in America's attitude toward the automobile. Now that most of us own a car, it has ceased to be a prestige symbol to impress the neighbors. Indeed, as the nation gets wealthier, impressing the neighbors becomes tougher.—M.K.

ife under Taxes

Many Americans look upon taxes as a burden; they do not recognize the positive forces, the benefits

THIS is the time of year when most of us are so concerned about how much we have to pay in taxes that we tend to forget about the things this money is used for: defense, conservation, education, and so on. To forget about the tax while pleading for the benefit, and to forget about the benefit when paying the tax, is very human. It is one of those psychological quirks we should guard against when subjected to the swollen rhetoric of the economizers on the one hand and the big spenders on the other.

Right now, it is the economizers who have the floor and are more likely to be listened to. Taxes, they tell us, are too high, and those of us who have just filed our income tax returns cannot help but feel the weight of their argument. And the argument does, in fact,

make a good deal of economic sense. But what the economizers tend to forget is that many of the things which we ask of government are by their very nature "uneconomic." Indeed, in our private enterprise economy, it is the function of government to provide us with precisely those services which private enterprise cannot profitably (i.e., economically) perform.

Take defense, for example, which, if we include our mutual security agreements with other countries, accounts for 63 per cent of all federal expenditures in President Eisenhower's budget for fiscal 1957-1958. Obviously, this is a function that only government can perform. Obviously, also, defense is not "economic"—our jet planes, guided missiles, H-bombs, etc., will never, we hope, be con-

sumed. And yet, all other benefits depend upon our ability to maintain such military strength as will deter any potential aggressor. Most Americans would agree that this service is literally priceless.

The same is true of many of the other benefits which our tax money buys. As our society has increased in complexity, not only have the traditional services of government (security, police and judicial administration, education, etc.) had to be vastly expanded, but government—particularly the federal government—has also been called upon to perform new functions. Some of these new functions, such as those performed by the Pure Food and Drugs Administration, the Atomic Energy Commission and the various other scientific agencies in government, were the almost inevitable consequences of scientific and technological progress. Some, such as the Federal Trade Commission, the Federal Power Commission and the Interstate Commerce Commission are agencies exercising certain regulatory powers to protect the general welfare. Then, there are the various government programs aimed to help specific economic groups, such as the administration's Soil Bank Program, whose existence is, for various reasons,

This article on life under taxes represents a joint effort by the editors of CHALLENGE.

felt to be threatened. Finally, and most important, there is the new role of government as the provider of economic security and social welfare for individuals. But to do all this, the federal government collected 72 billion dollar in taxes last year.

The need for tax funds has grown on all three fronts of government, the federal, state and local levels. Today, there is practically nothing we can own, use, eat and do that is untaxed by one of these levels of government. Indeed, some things like alcoholic beverages, tobacco and gasoline are frequently taxed two or three times before they reach the consumer because of frequent duplication of taxing powers of federal, state and local governments.

But while their taxing powers often overlap, the services supplied to the people by each governmental unit vary. Local governments in the main, provide police and fire protection, water and sanitation facilities, hospitals and public welfare assistance, highways and bridges, and schools and teachers. The state ordinarily assists local governments in providing and extending these and supplementary services.

Last year, all local governmental units in the country spent approximately 26 billion dollars to fulfill their functions. Only half of this—13 billion dollars—was col-

lected in taxes. The states, at the time, spent well over 20 billion dollars to perform their obligations, but received only 15 billion in taxes.

How were these differences made up? Federal government, with grants-in-aid of close to three billion dollars, helped the states meet part of their heavy financial responsibility; charges for services (in many states, for example, liquor stores are state operated)

and borrowing helped to meet the rest. As for the local governments, they made up their apparent deficit by receiving assistance from the states, by charging for water, electricity and other services rendered and by the famous expedient of issuing municipal bonds.

Federal assistance to states and localities also came in many other ways. Federal funds sifted down to the localities in the form of public works projects; home loans;

Tax Terms

Direct Tax: paid directly by the person on whom it is levied; it cannot be shifted or passed on to some other person. Examples are: personal income, inheritance and poll taxes.

Indirect Tax: can be readily shifted or passed on to someone else by the person who is required by law to pay the tax. Most sales and excise taxes are indirect.

Excise Tax: a levy upon some phase of the production and distribution of goods or services. For example, excise taxes are collected by the government on radio and television sets; automobile parts and accessories; furs, jewelry, toiletries; telephone and telegraph tolls; transportation of persons and property. The taxes are passed on to the eventual consumer. They are also called consumption taxes and internal revenue taxes.

Progressive Taxation: an increase in the rate of taxation as there is an increase in the base amount taxed. For example, 20 per cent on 2,000 dollars; 40 per cent on 20,000 dollars; 60 per cent on 200,000 dollars.

Regressive Taxation: a decrease in the rate of taxation as the base amount taxed increases. For example, six per cent on 1,000 dollars; four per cent on 10,000 dollars; two per cent on 100,000 dollars. A tax may be regressive in effect, however, even when the rates are uniform. A sales tax, for example, although applied uniformly, takes a larger percentage of the total income of low-income groups than it takes from the total income of higher income groups.

Capital-gains Tax: a federal tax levied upon the profits from the purchase and sale of capital assets, such as land, buildings and equipment that could not be disposed of without interfering with the operation of a business.

public assistance to the aged, blind and disabled; payments to farmers, unemployment insurance and Social Security benefits.

Of course, these "welfare" benefits could have been provided by the states and localities—if they had collected the taxes to do the job. But they did not and, as a result, the federal government has had to step in to assist the local and state units.

In the final analysis, the question of federal encroachment, like all other tax questions, is going to be resolved in innumerable compromises. In a democracy like ours, moreover, it is likely, though not inevitable, that these compromises will, in the long run, reflect what the majority of Americans think is in their best interests.

Three questions to ask

Knowing what is in the nation's (and, therefore, our) best interests is not always easy. But there are three questions we can ask ourselves whenever government embarks on a new program.

Are the benefits worth it? Can such benefits be met more economically and expeditiously through private expenditures? And, even more important, is private enterprise willing to do the job? This is not always the case. The unwillingness or inability of private enterprise to supply desperately needed power to Tennes-

see Valley residents and businesses led government to step in in the 1930s. It may well be that TVA costs the taxpayer more money than private development of the Tennessee Valley would have done. But in the absence of such private development, can we say that even an "uneconomic" project is better than no power at all?

Overwhelming need

On the other hand, the mere absence of a service does not necessarily mean that government should step in to provide it. Only when the community feels that there is an overwhelming need for a service which private enterprise is either unwilling or unable to perform, is there a case for government intervention. The present appeal for help by the people of the Southwestern states to save their drought-stricken and parched land from total destruction is a good example. Since the states and localities are unable or unwilling to supply the necessary funds, federal government intervention may be the only way of preventing the land from becoming a desert and the people on it from being reduced to poverty. Obviously, this kind of program is meant to sustain incomes and stimulate long-range economic growth. Many other government services, however, may do exactly the opposite by taking income out of the econ-

omy which could be more productively used by private individuals and firms.

How can government best raise the money? This is a very complex technical question which is easier to answer generally than in specific terms. By and large, Adam Smith's famous "cannons of taxation" which describe a good tax as one which is just, certain (i.e. easy to collect), convenient and economical still accurately describe the characteristics of a "good" tax.

Who is to confer the benefits and who is to tax? This is an extremely important question in our federal system. Economists and political scientists agree that, as far as possible, the functions and taxing powers of the three levels of government should be kept from overlapping. Unfortunately, this is easier said than done. In the complex kind of society we live in, it is obvious that some degree of duplication is unavoidable. As long as the need for huge federal expenditures persists (and it surely will as long as the cold war lasts), the states and localities will be forced either to find new sources of revenue or to tap the same sources as the federal government. Up to now, as both Professor Maxwell (*see page 18*) and Dr. Walker (*page 23*) point out, the states and localities have not been particularly ingenious in

seeking new sources of revenue. There has, therefore, been a good deal of duplication.

Indeed, it would seem that unless the states and local authorities show a greater willingness to raise the moneys they need, our federal system will become increasingly centralized. And very few Americans will admit, publicly at least, that they would like to see that happen.

A sure thing

These three questions—Are the benefits worth it? How can government best raise the money? and, Who is to confer the benefits?—must be answered in the context of each specific proposal for extended government services and higher taxes. The answers will, of course, differ in each particular case. Nor will the final solution always be a wise one. Even if we approach the problem scientifically—and that is not always possible—events may show our decision to have been a foolish one.

One thing is sure, however. As long as individuals live in organized societies, there will be taxes. Taxes, after all, are merely one way of paying for the satisfaction of human desires. The problem is to allocate our resources—both private and public—in such a way that these wants will be most economically and expeditiously realized. ■

It is no longer practical for a nation to regard taxes as merely an instrument for financing government expenditures

The Tax System: An Economic Stabilizer



by Kenyon E. Poole

IN 1929, internal revenue collections amounted to only three billion dollars out of a gross national product of 104 billion dollars. By 1955, federal taxes were taking a 66-billion-dollar slice out of a gross national product of 391 billion dollars. This increase, from three to 17 per cent, is behind the growing importance of taxation as a force for either stability or instability.

No longer can a nation afford to view taxes as merely an instrument for financing government expenditures; the impact of taxes on the level of output and employment must also be considered, and the possibility of *consciously* using the tax system as an instrument of economic control cannot be overlooked.

A few statistics will make apparent the tremendous role played

by the federal revenue system in the national economy. In 1955, corporate gross profits were 43 billion dollars; the corporate income tax was 21.5 billion dollars. Personal income in 1955 was 306 billion dollars; personal income taxes amounted to 31 billion dollars, or ten per cent. In addition, consumers paid out more than nine billion dollars in excise taxes.

These are the major federal taxes, accounting for nearly 62 billion dollars out of total federal internal revenue collections in 1955 of 66 billion dollars. What can we deduce from this about the impact of the federal tax system on economic stability?

Undoubtedly, the tax system provides a powerful brake against both downward and upward movements from full employment equilibrium, though we cannot de-

pend solely on this brake to prevent inflation or depression. Because tax yields rise in an upswing and fall in a downswing, the tax system has the effect of a mitigating factor in both situations. For example, rising tax yields diminish the ability of the public to spend; thus in times of "boom" there is a drag on inflationary tendencies. Falling tax yields increase the ability of the public to spend; thus in times of "recession" there is encouragement of stimulating factors. The larger the proportion of national income taken in taxes, the greater the impact of such effects.

Progressive rate structure

Moreover, the personal and corporate income taxes, which at present account for nearly 80 per cent of all federal taxes, respond to changes in income more than proportionally. Rising money income throws individuals into higher tax brackets, and with a progressive rate structure, makes them subject to a higher effective tax rate. Similarly, business profits fluctuate more violently than does national income, so that even under a flat rate corporate income tax, revenue yields of this tax likewise fluctuate more violently than national income.

The great tax discovery of the past 20 years is that the economy has, in the tax system, a kind of

"built-in flexibility" which can, on the one hand, cause money to be drained out of the economy into a treasury cash surplus when incomes and prices rise excessively. It can also, on the other hand, force money into the economy by way of a treasury deficit when they fall. But can this interesting feature of the tax system be depended upon to ward off inflation and depression? Let us look at a concrete proposal for an answer to this question.

A number of economists have urged that the federal tax system be permitted to operate as an automatic stabilizer. They say: decide upon the level of public expenditures, and then estimate the rates of the various federal taxes that will be needed to finance these expenditures under the assumption of full employment. Now, suppose something causes *private* spending to rise. At full employment, output increases are hard to come by; so prices will rise. But at fixed tax rates, tax yields will also rise, and, under a progressive tax system, rise more, proportionally, than national income. All the Treasury has to do is hold the budget surplus in the form of idle cash to brake the rise in income and prices.

This built-in flexibility is an in-

Kenyon E. Poole is Professor of Economics at Northwestern University. He is author of the book, *Public Finance and Economic Welfare*.

triguing idea. It operates in a downward direction as well. A fall in national income and spending below the full employment level means that tax yields will decline. With spending programs fixed, a budgetary deficit develops. The treasury must sell bonds to obtain the money that it would otherwise have obtained in taxes, and, if these bonds are sold to the banking system, the economy receives a stimulating injection of new money.

Fear of inflation

But is this enough to assure economic stability? Unfortunately, the answer is "No." We cannot rely on a *solely automatic* device to assure stable full employment. When the Treasury holds the budgetary surplus idle, it discourages inflation; but it does not necessarily succeed in reversing the upward movement in prices. In the downswing, moreover, the injection of new money undoubtedly arrests the decline in incomes; but it does not necessarily convert it into a movement toward the level of income that corresponds to full employment.

For many years the fear of inflation has been dominant in the minds of the control authorities. If the forces making for inflation are powerful, the excess of tax receipts over federal spending may not be enough to reverse the in-

flationary movement. Still, the tax system does not have to go it alone. One of the important factors offsetting the anti-inflationary rise in tax receipts is the disposition of businessmen and consumers to borrow from the banks in order to replace the additional money which they are paying in taxes. But the Federal Reserve authorities can force the banking system to discourage borrowing for this purpose. Indeed, it can go further and take positive action to reduce bank lending and private investment spending.

This monetary policy is not automatic. Yet, perhaps the greatest virtue of the built-in flexibility of the tax system is precisely its automatic nature. Automatic devices are difficult for pressure groups to attack; officials who exercise their judgments are vulnerable to attack. The Federal Reserve system, in adopting a tighter monetary policy, must make decisions, and these decisions may excite strong opposition from powerful interests.

Question of timing

It often takes courage to ignore group protests and to work for the welfare of the nation as a whole. For this reason, although we have much of the technical knowledge that is necessary to combine the automatic stabilizing action of the tax system with the judgment

of monetary authorities, there is much hesitancy on the part of politically responsible men to make full use of it. Quite apart from this, the all-important question of timing has to be decided. A mistake here could easily be very serious.

As of now no administration has contemplated, with much pleasure, the necessity of taking strong fiscal action for economic stability; and Congress has been even less willing to sacrifice alternative legislative objectives to the admittedly important goal of economic stability. Why?

The fact is that tax policy is a rather cumbersome weapon with which to combat month-to-month and year-to-year fluctuations in income and employment. It takes from six to nine months to get a major tax bill through Congress. Therefore, unless the fiscal authorities do a superlative job of forecasting, the remedy may be too little or too late. On the other hand, a sudden reversal of the economic situation may result in the tax changes coming into force at precisely the wrong time, actually adding to the difficulties they are supposed to remedy.

This obstacle to flexible fiscal policy may not be insuperable, however. The suggestion has often been made that Congress delegate a portion of its Constitutional power to tax to the Council of

Economic Advisers, or perhaps to a Congressional joint committee, which will have the power to vary tax rates within certain limits. After all, it is pointed out, there is precedent for this in the 1934 tariff provision, which gave the President the power to raise or lower tariffs by 50 per cent.

Instrument of control

It seems unlikely that Congress could easily be induced to delegate the power to make substantial or perhaps unlimited changes in tax rates even in the interest of economic stability. An obstacle, possibly only temporary, is the belief that the federal budget should be kept in annual balance. But even if, as a nation, we come to accept the use of budgetary surpluses and deficits as an instrument of control, Congress would still be loath to place so much power in the hands of one of its committees, let alone give it to a committee appointed by the President.

But we must remember that through the President and Congress a national economic control committee would be responsible to the people. This is a sobering fact that would face the political authorities every time a decision had to be made on whether to raise tax rates to avert inflation or to lower them in order to encourage private spending and employment.

Interestingly enough, the reaction of a Democratic administration to recession in 1948-49 was very similar to that of a Republican administration to similar circumstances in 1953-54. Both President Truman and President Eisenhower responded to these minor recessions, which nevertheless might easily have become major ones, by delaying action in the hope that the economy was merely passing through a period of readjustment. Both won the gamble; but the experience illustrates how much politically responsible people dislike to act at the appearance of every "minor variation in activity" that is "bound to occur in a free economy," to quote the January 1954 Economic Report of the President..

What, then, ought to be the role of tax policy in the control of the economy? The answer is plain when inflation or depression becomes severe. Tax rates must be raised sharply when the threat of inflation is serious, coupled with a tight monetary policy in order to discourage the public from borrowing funds to replace those they surrender in taxes.

In a really severe downswing, tax rates should be sharply reduced, although it has to be recognized that as long as firms and individuals think that prices are going to fall still further, they are likely to hang on to the dol-

lars which they do not have to pay in taxes. In order to increase the likelihood of recovery from depression, therefore, the federal government cannot take the risk of relying on tax reductions alone. It must also spend: on continental highways, economic development projects, and so on. This encourages rising demand for goods and the services of labor.

Taxation plays another role when the economy is on a fairly even keel at full employment—and we all want to keep it there. If consumption is running too high, excise tax rates on consumer durable goods can be raised substantially, a technique followed in England under the purchase tax. If corporations are plowing back and reinvesting too great a percentage of profits, a tax on *undistributed* profits can be enacted in the hope of encouraging distribution of dividends. Or if it is felt that firms should distribute fewer dividends—so that plant capacity and output can be expanded in order to reduce inflation in the consumer goods industries—a tax can be levied on *distributed* profits.

Many possibilities exist, and the financial history of most countries since World War II can be written in terms of their eagerness to experiment with their tax systems in order to stave off the evils of economic instability. ■



AMERICA 1975

SERIES

The States Widen Their Tax Powers

In many, the move is toward taxes on incomes; in others, toward increases in consumption levies

by James A. Maxwell

OF THE THREE levels of government in the United States—federal, state and local—the state governments have been the most successful in maintaining a stable position as collectors of taxes. In 1902, state governments collected 11.3 per cent of all taxes; in 1955, they collected 14.1 per cent.

But while the states' share of tax collections may have remained relatively stable, there has been a marked increase in both the absolute and per capita amounts of state collections. In 1955, state governments collected 74 times as much in taxes as in 1902. This represented a per capita increase of almost 3,600 per cent.

This increase in the *size* of state revenues has been accompanied by a remarkable change in the *sources* of state taxes during the past half-century. In 1902, the principal source of state taxes was

the property tax, which amounted to 53 per cent of all state collections. By 1955 the property tax provided only 3.5 per cent of tax collections; it was an important revenue source only in Nebraska (38.6 per cent). Clearly, state governments have relinquished property taxation to the localities and have tapped new reservoirs of revenue.

How did this change come about? Actually, the search for new revenue sources has proceeded by stages. The first stage, beginning just after World War I, involved wider and heavier use of income taxes (individual and corporate) and of death taxes (inheritances, estate and gift). The next stage began in the 1930s when state governments, faced with new financial responsibilities thrust upon them by the localities just when revenue from income

taxes was inevitably shrinking, turned to taxes on general sales or receipts. No less than 22 states enacted general sales taxes between 1933 and 1937. A related, though less significant, development was the increase of taxes on alcoholic beverages after the repeal of prohibition, and of selective excise taxes, notably on tobacco products.

Meanwhile, the widespread use of the motor vehicle provided the states with another very important source of revenue. By 1929, gasoline taxes alone accounted for 22 per cent of all state collections. But while creating new revenues, the motor vehicle also created new expenditures for roads, and no money was netted for use in meeting *other* governmental functions.

The principal trends in state revenues during the 1930s are still operating, though with diminished force. In 1955, the principal tax source of the states was the general sales tax which provided 22.8 per cent of all state revenues—a figure all the more impressive when it is recalled that only 32 states use the general sales tax. Next in rank is gasoline taxation, which accounts for 20.3 per cent of tax collections. And if collections for motor vehicles and operators' licenses are added to gasoline

tax collections, to form the category of highway user taxation, total receipts amounted to 30.5 per cent of the total. In the third place is income taxation, individual and corporate, which in 1955 accounted for 17 per cent of total tax collections. Alcoholic beverage taxes, selective excise, death and amusement taxes were other important sources of state revenue.

This brief rundown of the principal sources of state revenues should make it clear that the major source of state taxes today is consumption rather than income, property, or business. About 62 per cent of all state tax collections come from taxes on general sales, motor fuels, alcoholic beverages, tobacco products, motor vehicle and operator licenses—all of which rest wholly or largely on consumption. The remaining 38 per cent comes from business taxes in the form of corporate income and severance taxes (8.9 per cent); property, death and gift taxes (5.7 per cent); individual income taxes (9.5 per cent) and "other" taxes (14.0 per cent). Some part of these "other" taxes include miscellaneous taxes on consumption.

Of course, the pattern of revenue sources varies considerably from state to state. Highway user taxes are levied by all states, and so are selective excises, with liquor and tobacco the most important targets. Death taxes are

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levied by every state except Nevada. But only 32 states levy general sales taxes, 31 individual income taxes, and 22 corporation income taxes.

Moreover, the importance of these taxes varies in the different states. Thus, New York, Oregon and Wisconsin secure 50 per cent, 48 per cent and 46 per cent respectively of tax collections from the income tax; while some states do not levy any income taxes at all. West Virginia, Washington and Illinois raise 60 to 70 per cent of their revenue from taxes on general sales and selective excises.

Left with the crumbs

What of the future? Clearly, that depends to a large extent on the international situation. Should there be a World War III, for example, it appears likely that there would be a vast increase in federal taxation and the state and local governments would be left with the crumbs. Under such circumstances, centralization in federal hands of collection of income, death and probably commodity taxes seems unavoidable, with allocation of some portion of the proceeds being made to the state governments. This procedure was forced upon two other federal countries, Canada and Australia during World War II, and it seems likely that the pressure of another major war—even a vic-

torious one—would force a similar development upon the U. S.

What are the prospects if there is no war? Two alternatives can be assumed: (1) that genuine peace and disarmament shall come to pass or (2) that national security expenditures can be put on a "maintenance" basis.

First, let us look at the first alternative. What, in this happy event, will happen to state taxes? The historical parallel to such a situation can be found in the intergovernmental fiscal relations of the 1920s. In that decade, the weight of federal taxation was markedly reduced. In 1929 the maximum rate of the individual income tax was 20 per cent; the exemption for a married couple was 3,500 dollars and for a single person 1,500 dollars and the rate of the corporation income tax was 12 per cent. The commodities subject to federal excises were chiefly tobacco products, and on these the rates were about half our present rates.

While imagination can hardly be stretched to visualize a return to such levels even in the event of real peace, it is not fantastic to foresee a maximum rate for the individual federal income tax of 40 to 50 per cent, a per capita exemption of one thousand dollars, and a corporate income tax rate of 25 per cent. Such reductions in federal taxes would permit, and

encourage, state governments not now levying income taxes to do so, and states already using income taxes to broaden the base. The likelihood is, however, that the easing of revenue pressures would tempt the states to stay with the revenue patterns they now have.

Genuine peace would also see the abolition by the federal government of many of its selective excises and the reduction of the rates of federal excises on tobacco products and alcoholic beverages. Both of these moves would open important revenues to the state governments.

Much overlapping exists

And if this happened, it would present a golden opportunity to bring some semblance of interstate order into our state tax systems, and into the relationships between our state and federal tax systems. At present, there is much overlapping of taxes and little separation of tax sources among the state governments, between state governments and the federal government. Of the ten broad categories of taxation, at least 80 per cent are utilized by both the federal government and the states. Of course, the goal of *complete* separation of tax sources is neither feasible nor desirable, but some separation would mark considerable progress. Thus, most commodity taxation might well be

dropped by the federal government while taxation of inheritance and gifts might well be discarded by the states.

Even more important would be reform measures aimed at reducing tax conflicts and inequities. Some state taxes on businesses and commodities now operate (and are meant to operate) as interstate trade barriers. Some are designed to penalize out-of-state residents who draw an income from a given state. Such devices place uncompensated burdens upon business. They are inequitable among individuals, and they create a drag upon the efficient operation of our economic system.

What if the international situation remains more or less as it is now? In that case, major federal spending for national security may flatten out at a "maintenance" level. Federal spending for other purposes, notably welfare, will probably not increase as fast as gross national product. As a result, federal taxes as a per cent of gross product, and also per capita, will decline, leaving room for growth of state and local collections.

To finance growing expenditures, most state governments would probably have to expand taxation of consumption. Those not using general sales taxes would do so; those already using them would extend their use. It is not impossible that, in the future,

states with income taxes may experiment with an expenditure tax, graduated according to the amount of consumption by a family or single individual.

In spite of continuing increases in federal tax rates, additional use of individual income taxes by state governments can be anticipated. The states may also institute income tax reforms which will simplify administration and compliance, as well as raise more revenue. A number of constructive moves to bring state and federal income taxes into conformity have been suggested. Among them are: (1) Making the definition of income more approximately identical. Many of the differences which now exist are trifling, and even when they are of some consequence, reconciliation should be possible.

(2) Adoption of a flat per capita exemption in place of exemptions which are asymmetrical for a single person, a married couple, or a dependent.

(3) Adoption of withholding for wages and salaries approximately in conformity with the federal law. This would decrease tax delinquency, yield additional revenue, and ease administration and compliance. Adoption of withholding would put receivers of wages and salaries on the current basis, and this would enable all taxpayers to be put on a current basis by

estimated returns and payments.

In either case—whether we have genuine peace or a continuation of the cold war—it can be assumed that the federal role will diminish and that the state governments will, in the next two decades, play a relatively larger role. For, if there is no World War III, the functions of government which will rise in relative importance will be those which are the primary responsibility of the state and local governments, such as education, roads, social welfare, and so on. Under our federal system, the national government will play a peripheral part in handling these matters. It will assist by larger grants-in-aid, but a greater part of such responsibilities will fall upon the state and local governments.

But local governments in the future, as in the recent past, will prove weak as tax collectors because the sources opened to them are limited. For this reason, the state governments will step in, both by assuming functions from the locality and as beneficiaries of expanding grants-in-aid. While there will be some centralization in the performance of governmental functions, and even more finance at the state level, such a shift would be consistent with the nature and traditions of American federalism—much more so than a shift to the federal level. ■



Upheaval in Local Tax Patterns

AMERICA 1975

SERIES

It is at this level of government that we can anticipate the most striking revenue changes in the next decade or so

by Mabel Walker

TAX SYSTEMS, whether national, state, or local, do not exist in a vacuum. Imperfectly and with a lag, they reflect the trends of the times—political, social and economic. Two World Wars and a great depression, coupled with changes in economic developments and social attitudes, have changed the federal tax system into something extraordinarily different from what it was during the preceding century and a quarter.

A similar upheaval in tax patterns now appears on the local horizon. It is at this level of government that we can anticipate the most striking revenue changes in the next decade or so, even though the obstacles to effecting far-reaching tax changes on the local level are far greater than on the federal or state level.

Local governments are not sovereign units. They are crea-

tures of the state, and all their powers must be derived from the state. Sometimes the states delegate their powers through home rule provisions, or they grant wide taxing powers to certain categories of local units. More frequently, however, such fiscal powers as the local governments possess are begrudgingly doled out bit by bit.

Cities as well as suburban and rural governments are now feeling the impact of momentous economic changes, which frequently thrust upon them great financial burdens they are powerless to meet. New trends in transportation, housing, industrial plant location and retailing are some of the major changes that are presently pressuring local governments. Many of these changes are producing fiscal headaches for the central cities for, in the last

analysis, the cities are losing their relative share of population, industry and trade, and thereby also of taxpaying potential. When there is any replacement of the outgoing population, it is likely to be by newcomers with lower income status.

Meanwhile, demands for governmental services in the central cities increase substantially; and demands for governmental services in fringe areas skyrocket as rapidly growing sections find it necessary to provide water and sewerage facilities, schools and other costly capital improvements. Such demands must be met, however imperfectly, in addition to vastly increased operating costs.

Some dramatic increases

These problems are superimposed on the major problems of steeply rising costs of local services. Some of the more dramatic increases stem from the extraordinary and unexpected rise in the birth rate following World War II, necessitating a vast new school building program and more teaching personnel; the unprecedented and also unexpected increase in motor vehicles, requiring large outlays for road and highway construction; and the rapidly increasing demand for water, occasioned not only by population and industrial growth, but also by accelerated per capita use

for personal and industrial purposes.

Underlying the problem of finding new revenue sources is the troublesome factor of illogical and overlapping governmental units. The financial problem would be difficult enough, even within a framework of local governments streamlined for today's needs; without such a structure it becomes extremely baffling. Cities today are forced to demand direct financial aid from the states and more power to raise money locally.

Local governments derived their tax revenues almost entirely from property taxes until very recently, and they still get approximately 85 per cent of local tax money from this source. But this figure is an average one for all local governments. The proportion is less in the cities, and even less in the larger cities. Cities in the 25,000-250,000 population category obtained 82 per cent of their revenue from property taxes, while cities over 250,000 obtained only 69 per cent from this source. New York City now gets 65 per cent of its tax revenues from the property tax, and Philadelphia only 46 per cent.

For 100 years or so, the property tax was a heavy revenue producer, constantly yielding more

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revenue as cities grew rapidly and as wealth increased in the country. But the wealth of the country came more and more to be represented by intangible personal property, and more and more it became possible for taxpayers to avoid taxes on such property. The movement to omit certain types of property from the tax base developed and spread, and the property tax base was whittled away considerably. New York and one or two other states have now limited, or almost limited, the tax to real estate.

About 30 years ago, the rapid growth of the cities began to slow up, and increases in real estate values were no longer sufficient to take care of the rapidly expanding revenue needs of the cities.

"Snob zoning"

Nevertheless, there is every reason to believe that the property tax will continue to be a major revenue producer for local governments for many years to come. It is important, therefore, to give thought to some unfortunate effects of supreme reliance upon this tax. There is a growing tendency to evaluate new homes, new industries and various types of development mainly in terms of the property tax. Such measurements are resulting in "snob zoning" in some sections as more prosperous communities try to bar

families of moderate income because the education of their children, and the other governmental services rendered to them, will cost more than the taxes that can be collected on their property. Community segregation by income groups, and by age groups, results.

The time-honored and generally accepted criteria by which to judge a tax system are its equity, its administrative feasibility and its productivity. A tax system must be sufficiently productive to do the job it is called upon to do; if it is not, then either fiscal irresponsibility or a breakdown of governmental services will result. Moreover, if the tax system cannot be administered, it is useless to give it further consideration. The principle of fairness or equity is universally accepted, although honest differences of opinion may and actually do arise as to what constitutes equity. Equity is something we approach, but do not attain. No tax is, or can be, completely fair in all its aspects. Some, however, are more patently unfair than others.

But it is not enough for a tax system to be productive, administrable and equitable. Governmental units must consider the possible economic repercussions of a tax before it is actually imposed, lest the tax sap their economic vitality. A tax that is discriminatory upon a specific industry, for

example, is likely to have a deleterious effect upon the locality.

Moreover, it seems increasingly important in these days of extensive commuting across governmental boundary lines that the sorely burdened central city should derive some financial support from the great number of persons who make their living in the city, but choose to live and pay their taxes in another governmental unit.

Time is of the essence in meeting current fiscal needs, and local governments cannot wait until political scientists devise the perfect pattern for governmental units; until political reformers can secure political and popular acceptance of such a pattern; and until fiscal scientists produce the theoretically perfect plan for financing the perfect unit. Under the harsh pressure of circumstances, new local finance patterns appear to be emerging more from the crucible of actual experimentation than from detached and scholarly research.

Flat-rate taxes

The most important new local tax is the flat rate tax on income and profits. It came upon the scene rather fortuitously in the late 1930s, when Philadelphia, confronted with a fiscal problem of great magnitude, hit upon this tax as a device that would be with-

in its constitutional and statutory powers. The tax was roundly condemned by many persons, but it worked, and it stuck. Presently other cities saw that the tax was yielding heavily, that it could be administered reasonably well, and that it produced some revenue from the commuting population.

The tax has been spreading gradually since that time. Flat rate income taxes, usually at one per cent, are now imposed in 27 cities with a population of 25,000 or more and in a number of smaller communities. There are serious objections to the local income tax for smaller units of government, but for the larger central cities it offers a productive and administrable source of revenue. Opinion differs concerning the fairness of the tax, but it is at any rate more equitable than the sales tax.

The hard-pressed cities have also made wide use of service charges. Sewer rentals, refuse collection charges, water rates and parking meters are some of the more widely used service charges.

A relatively new phase of this development is the intergovernmental service charge. Some of the more acute problems in fringe areas center around water supply and sewage disposal. Because of the heavy capital investments in such services, and the economy and efficiency made possible by

providing them over a large area rather than on a piecemeal basis, some central cities are providing water and sewerage to outlying areas. Fire and police protection and planning services are also sometimes provided to the surrounding communities by central cities. Usually, but not always, the central city charges either the fringe governments or the benefited individuals in such areas for the services. The practice of these intergovernmental fiscal arrangements among local governments seem likely to increase.

A costly privilege

A privilege tax on urban motorists is being increasingly advocated. It is argued that urban motorists cause a great deal of the traffic congestion, safety hazards, air pollution, noise and other undesirable effects; that they are a costly burden to the city and a disruptive influence; and that, moreover, they have weakened mass transit support so that cities have been compelled to subsidize such facilities heavily.

The use of the city streets by a private car, therefore, is a privilege, which can be enjoyed by only a limited portion of the population. Those persons enjoying this privilege, it is argued, should pay some special tax for it. Such a tax should preferably be at a higher rate for the nonresi-

dent. Although privilege taxes of this nature have not yet been tried there is such an increasing number of suggestions along these lines that it seems reasonable to anticipate something of the sort. It may come in the form of an annual license fee for residents, coupled with an entrance toll on main highways for nonresidents, or it may take other forms.

Experiments are being carried on with various other local taxes. Some—sales and gross receipts taxes, for example—are productive and in the very large cities can be administered reasonably well; but they affect business enterprise and have far less relation to taxpaying ability than the flat rate income tax. Moreover, sales taxes can be, and undoubtedly are, largely avoided by commuters from other governmental units.

Other forms of experimental taxes, such as local admissions taxes on theatre, sport and other amusement tickets, have worked well and are being used by a number of cities. A tax on hotel rooms is imposed in a few places, but the revenue from it does not amount to much.

These experiments may force us to modify our traditional tax concepts. We must evaluate economic and social changes that are taking place and devise methods of coping with the resultant governmental and fiscal problems. ■

Have we maneuvered ourselves into a position where it is politically impossible to carry out fundamental improvements in the income tax?

Bargain Counter Psychology

by William Vickrey



AT ABOUT this time of year millions of us are struggling with our federal income tax forms. In many cases, state income tax forms must also be filed; and, for some, even municipal income tax problems await attention. After coming up with a fairly substantial figure of federal income tax assessed, we are in most cases relieved to discover that this has substantially been taken care of by withholding; either we have only a relatively small balance still to pay, or we can, perhaps, even expect a refund.

But while the payment of staggering sums has thus been rendered relatively painless by the withholding process, there remains this disturbing question: Does the sum abstracted from wages or salaries in such an unobtrusive fashion represent the in-

dividual's fair share of the enormous military and civilian expenditure of our governments? At first, when we let our eyes stray towards the upper ranges of the tax table, where for the 50,000-dollar to 60,000-dollar income bracket the tax rate is 75 per cent, and, indeed, 91 per cent on incomes over 200,000 dollars we may feel that perhaps we are not too heavily taxed in relation to what the larger incomes have to pay.

But wait a minute! Do these rates really mean what they say? With capital gains taxed at only 25 per cent, with municipal bond interest totally exempt, with many other items taxed partially or not at all, and many other dodges available for reducing tax liability, it is only a small minority of the upper bracket taxpayers who bear net tax burdens that are

anything like what the nominal rates would suggest. In 1951 it was found, for example, that taxpayers with adjusted gross incomes of over a million dollars paid an average effective rate of only 48 per cent of reported income, not counting such items as tax exempt interest, depletion allowances, or other nontaxable income. The nominal rates on such income would have produced a tax bill of over 85 per cent. The situation is no better now.

Moreover, the high rates produce remarkably little revenue. In 1951, out of a total tax liability of 24.2 billion dollars, only 830 million dollars or less than 3.5 per cent, would have been lost by levelling off the rates at 50 per cent on all taxable income in excess of 32,000 dollars for married couples (16,000 dollars for single persons).

How did we get into such a position? In the United States, as in many other countries, extreme progressive rate schedules are the relics of wartime finance. In wartime, when pressures for increased government revenues are heaviest, extreme rates are enacted largely as a means of persuading the mass of taxpayers that the burdens are being equitably distributed.

But with heavy revenue requirements continuing into peacetime,

it has proved politically impossible to reduce these top rates to a more reasonable level. Democratic and Republican administrations alike have shrunk from appearing to favor the rich in their tax reduction programs. At the same time, the growing look of permanence about the high rates and the relaxation of wartime fervor and pressures have led to widespread adaptations which minimize the impact of high rates.

The result is a great pretense of progressivity, but this progressivity is invalidated by the increasingly generous provision of loopholes. The unsophisticated voter is thus led to believe that the degree of progression is greater than it actually is, while in reality the incidence of the tax becomes more and more capricious, depending on whether individuals are in a position to avail themselves of the loopholes.

But the problem of loopholes is not confined to the top income classes, though it is there that the situation is aggravated by the extremely steep rates. The little taxpayer, too, by dint of persistent clamor, has been let in on the fascinating game of special deductions and exemptions, provided, that is, that he has sufficient time, patience and persistence to ferret out all the favorable possibilities, or can pay a tax specialist to do the job for him. Thus, while the

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special capital gains provisions applied only to upper bracket taxpayers until 1933, now even the small investor can be exempt from tax on half of his capital gains. Many of the most widely used special deductions have no equitable justification; in most cases they were introduced in times of much more modest rates and lighter tax burdens. Their continuation can be explained only on the theory that the taxpayer's bargain-counter psychology is being pandered to by allowing him deductions; although, of course, this is merely to offset the fact that rates are higher than they would be if a tighter rein were kept on deductions in the first place.

Inequities are cited

There is no particular merit, for example, in permitting the motorist to deduct his gasoline taxes and even his license fees, (particularly as these funds are largely used to provide him with roads), while the person who rides a taxi, bus or train can take no deduction for the corresponding taxes which he pays indirectly. Indeed, if he uses public transportation for long trips, he pays a federal transportation tax in the bargain, which he is *not* allowed to claim as a deduction. Similarly, the home owner not only does not pay a tax on the "imputed" income that he derives from his equity in

his home (and which is the counterpart of the cash income he would have derived and paid tax on had he invested in securities and used the proceeds towards rent) but, in addition, he is allowed to deduct property taxes on his home, while the person renting a house or apartment gets no comparable tax allowance. The large number of "cooperative" luxury apartments to be found along Park Avenue and in other high rental areas of New York City does not indicate, necessarily, any special fondness of the inhabitants for the cooperative principle. Rather, it reflects the advantages of paying a large part of one's rent with tax-free money.

These various deductions, ranging from the arbitrary and inequitable through more defensible ones (such as those for charitable contributions and abnormal medical expenses), amount in the aggregate to a sizable sum. National income estimates of the Department of Commerce for 1955 show personal incomes of individuals amounting altogether to 303 billion dollars. Only about 125 billion dollars of this sum is estimated to be actually subject to the individual income tax. Of the difference, 101 billion dollars perhaps can be accounted for by personal exemptions, including income accruing to persons below the exemption limit and not filing returns.

There remains 77 billion dollars which could, in theory, be made subject to tax. If this sum could be brought into the tax base, income tax rates could be reduced from the present range of 20 to 91 per cent to a range of 13 to 56 per cent. One can hope that most taxpayers would be willing to trade all of their miscellaneous deductions and special allowances for such a reduction in the rate!

Unrealistic reduction

But such a reduction is, of course, hardly realistic. Some of the 77 billion dollars represents income that is either underreported or not reported at all, and even with improved administration and the reduced incentives for evasion that would come from lower rates, some evasion is likely to continue. Some of the 77 billion dollars represents deductions that seem warranted to many taxpayers, even if such allowances mean higher rates—for example, additional exemptions for aged and blind persons and for charitable contributions. Even so, if reform were limited to the restoration to the tax base of only those items such as nonbusiness tax deductions, imputed rent, and so on, it would seem possible to increase the yield of the income tax at present rates by as much as one-fourth, or, conversely, to lower the rates proportionately to a range of 16 to 71 per cent.

It is quite likely that some and perhaps all of the nominal loss resulting from a leveling off of the top rates would, in fact, be recouped as taxpayers responded to the greater incentives by producing larger incomes, or, more likely, refrained from cultivating the various avenues of avoidance quite so assiduously. A taxpayer subject to a 90 per cent rate who has 1,000 dollars of income that he might receive in taxable form may be happy enough to fall in with a scheme for converting this into 200 dollars of capital gain. He will let the remaining 800 dollars go to waste, since at the 25 per cent capital gains rate he would net 150 dollars, whereas 1,000 dollars of fully taxable income would net him only 100 dollars. If we reduce his regular rate to 75 per cent, so that he can retain 250 dollars, the capital gain scheme will no longer look attractive, and the tax revenue will be 750 dollars instead of 50 dollars. It would not take much of this kind of shifting to make up the loss in revenues implied by a leveling off of the top rates.

Reasonable as such changes might appear, prospects for anything of the sort seem dim indeed, judging from the past history of the income tax law. Beneficiaries of particular provisions are often well organized in pressure groups of one sort or another, and the advantages of a special allowance

are often much more vivid than the more thinly spread rate increase to offset the revenue loss.

Revenue acts, moreover, have a habit of being either predominantly tax-raising or predominantly tax-abating. When there is tax reduction to be apportioned, loophole-closing provisions usually get scant consideration, and the advocates of steep progression are able to muster sufficient support to prevent even as much reduction in the top rates as would correspond to a uniform percentage reduction in the burdens of all taxpayers. On the other hand when revenue needs are increasing, any proposal to reduce rates can hardly get a hearing.

More fundamentally, moderate efforts to secure an equitable tax system with a sane degree of progression are likely to be frustrated, first, by the tendency of the advocates of steep progression to rest content with the appearance rather than the substance of progression, and second, by the (possibly quite realistic) fears of upper bracket taxpayers and their spokesmen. After all, while loopholes once closed might remain closed, it is much more difficult to insure that rates once lowered will start upwards again. And, as long as the loopholes stay, the burden cannot get much worse, since no one is going to put the rates up to over 100 per cent. With

loopholes gone, the wealthy would be much more vulnerable to progressivitis. Their enthusiasm for any such "deal" is, therefore, likely to be lukewarm.

"No tax law can be perfect," said Paul Strayer at the 1954 meeting of the American Economic Association. "It is clear, however, that few can be as bad as the current income tax law and still command the respect of any intelligent citizen or economist." If nothing is done, we can expect to continue to see large sums spent on "taxperts" to guide the taxpayer to the nearest loophole; to see taxpayers buying houses for the sake of the tax advantage when they would normally be better off renting and preserving their mobility; and to see people encouraged by just another straw's weight to add their car to the growing congestion of our downtown streets rather than use public transportation. More seriously, the growing awareness of the jerry-built patchwork of the tax may lead to less and less willingness on the part of taxpayers to comply in full with its provisions, and greater and greater readiness to resort to dubious tax-reducing devices. The question is, can we do something about this situation? Or have we maneuvered ourselves into a position where it is politically impossible to carry out any fundamental improvements? ■



The Excise Reservoir

by C. Lowell Harriss

Although at the present time consumption taxes constitute a large source of revenue, there is room for expansion

IN THE federal budget for 1957-58, taxes on consumption are expected to yield about 13.2 billion dollars—or roughly one-seventh of the total federal revenues of nearly 86 billion dollars (including payroll taxes and non-tax revenues). While this may seem like a great deal of money, many countries make relatively heavier use of the various types of consumption or excise taxes—taxes on commodities, services and expenditures. In addition to the federal government's "take," the 48 state governments will impose their own levies; in 1956 they got more than 50 per cent of their total tax revenues from levies on sales and gross receipts.

Now, is the federal government failing to take full advantage of this revenue potential? The National Association of Manufac-

turers, among others, believes it is. The NAM favors a broad federal tax at the manufacturing level to permit a reduction in income taxes. At the same time, many industries whose products are now subject to a federal tax object to specific features of the present levies.

There is no question that the present "system" grew haphazardly, and it would be a miracle if impartial study indicated no room for improvement—especially if we focus attention on future needs rather than past emergencies.

What are our major consumption taxes today? The following classification (deliberately ignoring the tariff) is rough but still useful.

(1) *Taxes on alcoholic beverages and tobacco.* Here are the biggest revenue producers. They have been justified as burdens on

bad habits and as penalties for doing what should in any case be discouraged. Today, most experts would probably advance this argument seriously only for the tax on hard liquor, although they would agree that drinking can be evil both to the drinker and to others in society and that the high price of taxed liquor will, undoubtedly, somewhat discourage heavy drinking. However, the main defense of liquor and tobacco taxes today is that they bring *large revenues from the great masses of the public without great complaint*. Revenue pours in precisely because people do *not* give up the pleasures of smoking and drinking, even if the tax is a big part of the retail price.

(2) *The tax on motor fuels.* This tax falls in a class by itself. Until 1956, gasoline tax revenues were treated as a source of general revenue. But with the increase from two to three cents per gallon made in connection with the Highway Act of 1956, these funds have in effect been earmarked for construction of facilities directly benefiting motorists. This tax, then, is more like a charge for use of facilities provided by government. The same applies to the tax on lubricating oils.

(3) *Taxes at the manufacturing level.* There are several such taxes imposed, mostly at a 10 per cent rate. Autos and trucks, radios and

TV sets, sporting goods, phonographs and records, business machines, refrigerators, electric and gas appliances, tires and tubes, firearms, cameras and film are the most important items taxed in this way. Two rather different reasons have been advanced in support of these taxes. The first, prominent during the 1930s when some of these taxes were originally imposed, was that these items are luxuries in the sense that a person buying them generally has more than a minimum ability to pay and can avoid the tax by doing without something that is not truly essential. The second reason became important early in World War II and during the Korean fighting, but it has no significant bearing today: namely, the tax would not only bring revenue, but it would also reduce consumption, thereby freeing manpower, factory capacity and materials for essential war production.

(4) *Taxes (now at a rate of 10 per cent) collected at the retail level.* These include taxes on jewelry, toilet preparations and cosmetics, luggage and furs—as well as taxes on such things as club dues, admissions, cabarets, playing cards and safety deposit box rentals. The justification, when one is given, is that these are luxuries, or at least not necessities.

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(The difficulty of making a sensible distinction between luxuries and necessities in a civilization like ours is far greater than commonly recognized.) These taxes are less hidden from consumers than those imposed at the point of manufacture.

(5) *Taxes on telephone, telegraph, freight and passenger transportation services and certain security transfers and deeds.* Here again, there has been a mixture of reasons: to reach things that are not necessities; to discourage use during war when facilities were overcrowded; and to get revenues from broad-based taxes.

(6) *A miscellaneous group of taxes on state bank notes, machine guns, gambling and opium.* These levies are to be judged on their merits as policing or regulating devices rather than on their success as revenue producers.

A broader criticism

In general, this assortment is neither very bad, nor outstandingly good. The taxes on transportation are unquestionably bad for a variety of reasons—including the important fact that they discourage use of the common carrier and mass transport facilities and favor the auto and owner-operated truck, thus adding to the need for more spending on streets and highways. The levy of \$10.50

a gallon on hard liquor may well be so high that, by encouraging bootlegging, it not only deprives the Treasury of some revenue but also encourages lawlessness and the consumption of poorer quality liquor. One could find other defects in specific taxes, but many of them would be part of a broader criticism of consumption taxes in general.

This broader criticism is that such taxes discriminate among consumers on the basis of consumption habits or preferences. People in essentially similar circumstances must pay different amounts because they want to consume different things. But price differences due to taxes will induce some change in their spending. As a result, some individuals as consumers or producers are hurt more than others, and the basis of the differences has little logic, especially in peacetime. Most arguments in defense of present discriminations seem rather weak. Even allowing for exaggeration, one must recognize that distortions in the use of resources are inevitable and that these distortions are hardly in the public interest. On the other hand, the 1954 reductions in several rates from 20 to 10 per cent removed some of the worst discriminations, and the gradual clarification of administrative rules as well as the adjustment of business practices has

somewhat reduced the seriousness of others.

Another broad criticism of excises is that the system is regressive—that is, consumption taxes tend to take a larger percentage of the total income of the lower income groups than of the total income of higher income groups. This is true of taxes that are business costs, e.g., those on freight. More significant is the fact that some families with very low incomes do smoke, drink, use electric light bulbs and consume other taxed items. Yet, one merit of our selective excise system is that the items taxed have been chosen so that the burdens on the very poor are generally light. Besides, the regressive impact on those above the desperate poverty line will generally be more than offset by the progressive rates in the income tax.

Effect on the economy

There are other important criticisms of consumption taxes. Such taxes tend to conceal costs of government and reduce pressures for economy. They enter the cost of living and parity price indexes and thus provide some excuse for other price rises. They create many problems of administration and compliance, and they absorb relatively too much purchasing power, thereby depressing the economy when business is poor. Finally, federal

use of consumption taxes is condemned as threatening the principal source of state revenues.

Does the existing system hold promise of larger revenues in the future to finance growing government expenditure or to help bring about reductions in other taxes? Yields from consumption taxes will certainly grow as the economy expands, though somewhat less proportionately. The fact that key rates—those on liquor, tobacco and gasoline—are fixed in money amounts, rather than as a percentage of price, removes one source of potential revenue growth in an economy with a rising price level. Indeed, a very considerable rise in national income would be required before the excise tax could be brought to provide another five per cent of present federal revenues.

Given our probable rise in national income, how could we get substantially larger excise tax revenues? Well, Congress could raise rates or enlarge the list of items taxed. Or it might substitute a broadly based tax, perhaps like Canada's 10 per cent tax on a very wide range of manufactured products, or Switzerland's tax at the wholesale level, or France's tax on value added, Germany's tax on turnover, or those of our states on retail sales. Certainly, these possibilities deserve more study than they have so far received.

Actually, the best argument in favor of consumption taxation today is one that had little merit before World War II—namely, that by raising revenue through such taxes, we make it less necessary to push income tax rates to dangerous levels. Even those economists who, like the author, believe that the personal income tax is by far the best source of large revenues recognize that it can be used too extensively and that rates can go so high as to produce inequities, economic distortions and a variety of other undesirable results.

While it is possible that today's high personal and corporate income tax rates have not had significantly adverse effects on the economy, this might not hold if a new emergency were to require much new revenue. In that case, heavy reliance on the income tax might have a very serious effect on incentive and the rate of capital accumulation. In such a situation, it would be well to have in reserve, to meet these new needs, a revenue source with a big potential—operating at a low rate that could be boosted promptly.

Defenders of excise taxation also point out that a broadly based tax which excludes rent and food can produce substantial revenue without great burdens on the poor. Besides, rising incomes are lifting more and more families out of destitution and poverty.

What, in the light of probable trends in the foreseeable future, should be done? Economic analysis does not, in my opinion, lead to a clear-cut case for or against greater use of excise taxes. The decision would have to hinge upon the nature of the change and of the other changes in our tax system which it would make possible. At the moment, there seems slight prospect of important revisions in our excise taxes or of their place in the whole revenue system.

A broad tax at the wholesale level, and a tax on value added by manufacture (in other words, a tax on the wages, interest and profit, and depreciation incurred at each stage of production), are two possibilities that call for more study. Indeed, the whole subject needs careful analysis before any major change can be considered.■

Answers to Challenge Quiz

- | | |
|----------------------------------|----------------------------------|
| (1) True (<i>see page 42</i>) | (7) True (<i>see page 18</i>) |
| (2) False (<i>see page 23</i>) | (8) True (<i>see page 28</i>) |
| (3) False (<i>see page 13</i>) | (9) False (<i>see page 33</i>) |
| (4) True (<i>see page 58</i>) | (10) False (<i>see page 8</i>) |
| (5) True (<i>see page 47</i>) | (11) True (<i>see page 68</i>) |
| (6) False (<i>see page 50</i>) | (12) True (<i>see page 63</i>) |

Economics in Action

**who's to
do the
spending?**

The budget proposed for the 1957-1958 fiscal year is the highest peacetime budget in the nation's history—71.8 billion dollars. This has evoked considerable discussion of balancing budgets, despite the fact that this one is not only balanced but projects a surplus of 1.8 billion dollars. The deeper issue is that of government spending *vs.* private spending. On the one side are those who feel that the less government spending the better, and that economic growth is best left in the hands of private business. On the other hand are those who believe that government spending and taxing provides an economic tool with which the government can work towards balanced growth and sound credit for the whole economy.

**let the
Congress
cut**

Despite this fundamental disagreement, everyone believes that both economy and efficiency are necessary. Almost everyone also agrees that when taxes are too high they discourage rises in productivity, incomes, consumer demand and, therefore, expansion. The question is: When are taxes too high? Now, says Secretary of the Treasury Humphrey. And the President agrees with him, but asks what can be done when high defense costs are necessary, and can be expected to continue until there is world agreement on disarmament. Combined with this, Mr. Eisenhower points out, is the continuing demand of the American people for services, and as long as they want these benefits it is up to the government to provide them. Both he and Mr. Humphrey will be happy to have the budget cut, but the administration cannot see how to reduce its proposals. So, the administration is asking Congress to cut it, since Congress is both discontented

at its size and the originator of many of the costs already included in its proposals.

**changing
proportions**

As a matter of fact, our expenses for national security and related programs have decreased since Mr. Eisenhower first took office. The total for defense in the 1954 budget was 47.8 billion dollars as compared with that for the coming fiscal year, 45.3 billion dollars. As defense spending has decreased, spending for civil benefits has increased, and has not yet reached its peak, apparently. During the President's first year, civil government costs amounted to 20 billion dollars; the 1958 estimate is for 26.5 billion.

**defense
still the
biggest
slice**

Even so, by far the largest part of the budget for 1958 will go to maintaining and improving our own defenses and strengthening the defenses and economies of other countries in the interest of collective security and world peace. This protection takes 63 per cent of the budget. Civil benefits account for 24 per cent; interest on the national debt, ten per cent; and all other operations, administration and contingencies, three per cent.

**the
proposals**

The proposed increase of 2.6 billion dollars for security is especially to facilitate the development, purchase and maintenance of new weapons, but for mutual assistance as well. There are also substantial gains over the 1957 budget for labor and welfare (506 million dollars more), veterans benefits (176 million, agricultural aid (264 million), school construction (185 million) and natural resources (167 million). Smaller increases are requested for international affairs and finance, and interest on the public debt. Decreases are estimated for commerce and housing, and for general government, in part because of a change in accounting. If the proposal to increase the postal rate is accepted, the postal deficit will also be decreased.

**additions
and
subtractions**

Congress has a tendency to increase rather than cut proposed budgets, and cutting won't be easy. Defense may even be boosted, especially for the Air Force, but foreign aid may be pared down. School construction may also be reduced, as may welfare costs, but the amount for agriculture would be extremely difficult for Congress to trim, considering its political overtones. The highway construction program, which is not included in the budget since it comes under a separately financed trust fund, will not be under consideration. Whatever changes are made, therefore, will probably make little appreciable difference in the total amount.

a dilemma

Big budgets encourage inflationary tendencies, and the government's current dilemma is that the present cost inflation in its turn makes for increased government spending.

* * *

**economic
storm
clouds**

WASHINGTON—The nation's capital is agog, as is the rest of the country, with all the talk about inflation, wage-price controls and a possible depression. Treasury Secretary Humphrey's warning of economic troubles ahead if the rate of federal spending cannot be pared was not coupled with any suggestions of how that miracle might be achieved. Former President Herbert Hoover's warnings of gathering economic storm clouds did not sit well with people who have been complaining bitterly about the administration's "tight-money policy." The "self-restraint" thesis of the President has been viewed with a jaundiced eye by both management and labor groups. In short, the only thing there is agreement on is that either the boom continues, or the bust comes. Neither alternative is desired. There is a growing realization that mild inflation, but constant inflation, along with full employment policies and large federal budgets are here to stay. Wages and prices will continue to edge upward. The dollar will continue to take a beating.

**unhealed
wounds**

The united labor movement closed out the mid-winter meeting of its Executive Council, but the Miami sun did not heal old wounds. Feuding groups convinced the merged leadership that it would take at least another two years before the parent body could speak, without fear of contradiction, for all of the various unions and locals within the AFL-CIO. Troubles with the Senate's investigating subcommittee have bared the wide gap that exists between the policy pronouncements of the Executive Council and the actual operations of the working union heads. The decision to go ahead and try to get 13 million unorganized white-collar workers into the union fold was made with fingers crossed. Jurisdictional disputes could do permanent damage to the merged labor union movement, which admittedly needs consolidation. The merger will stick after a couple of splinters, but the foray into the white-collar world will not be successful.

**Middle
East
vacuum**

The President's Middle East plan has made headway to the extent of winning the approval of King Saud, the influential Crown Prince Abdul Illa of Iraq and Foreign Minister Malik of Lebanon. Iran, Jordan and Turkey are also in the Western camp. Only Syria and Egypt remain doubtful, and they are being outmaneuvered. So far, so good. There remain the touchy problems of Suez and of Egyptian-Israeli controversies. A United Nations' settlement in both areas is definitely the next move. Nasser will get his pound of flesh in the form of control over the Canal, but he will accept UN stipulations on how the Canal should be run and maintained; and he will accept, as will Israel, UN guarantees concerning Gaza and the port of Aqaba. Some sort of neutralization in both places will be worked out. The administration has tried very hard to fill the Middle East vacuum with UN initiative and has used American economic and military aid to convince the Arabs that UN influence is better than Russian intervention. The biggest gainer to date in the Middle East chess game: the King of Saudi Arabia. ■

Are We Taxing Away Incentives?

by William C. Freund

We must move gradually toward a tax system which encourages the taking of risks—and, therefore, the growth of the economy

FINANCING the United States government is a colossal undertaking—with some 170 million Americans pouring the fantastic sum of 72 billion dollars a year into the Treasury's coffers. By contrast, General Motors, which boasts the largest annual revenue of any American corporation, comes out a poor second to the government with its gross take of 11 billion dollars.

The Secretary of the Treasury has available to him a power of which corporation treasurers might well be envious. He has the power, conferred on him by Congress, to levy taxes on individuals and corporations without regard to the goods and services specifically rendered to the taxpayers.

But the federal government is not a business selling a product or a service. It is a social institution in which all Americans are partners, acting together to "pro-

vide for the common defense and the general welfare."

The partners in this social enterprise contribute according to some approximate measure of their ability to pay. There will never be complete agreement on what constitutes a fair and equitable tax system. Each taxpayer can advance good reasons as to why the particular taxes which he pays should be reduced.

But a significant over-all tax reduction for both individuals and corporations, while desirable from many points of view, would force a curtailment of essential functions of government. It is simply not possible to grant substantial tax reductions to all. The net cash surplus of the Treasury, while encouraging, amounted to about seven billion dollars in 1956; if tax rates remain unchanged, it will probably not exceed five billion dollars this year. For this

reason, our purpose here is not to argue in favor of major tax cuts. Rather, it is to recommend changes in our tax laws which will, without compromising the Treasury's fiscal needs, give taxpayers added incentives to invest in the growth of a competitive economy.

Few things are as important to the American system as a spirit of enterprise, a willingness to take a chance. Without risk, there is no economic growth. As long as we produce the same goods and services in the same old way, our standard of living will at best remain stationary. Our material progress depends upon the innovators—those who stand ready to introduce a new and better product, to take a chance in the hope of great rewards. We must not rob them of their incentives.

Under our tax system, the incentives of individuals and corporations can be strengthened in many ways. The individual income tax is so graduated that the higher the income the greater the rate of tax which must be paid. For example, after all deductions and exemptions, a married couple with a taxable income of four thousand dollars is assessed at 20 per cent. The next four thousand dollars of income are taxed at 22

per cent, and so on up the ladder of progression to a peak of 400,000 dollars and over, at which point the tax becomes 91 per cent.

It might seem, at first glance, that at some point the graduated income tax becomes high enough to remove the incentive to work. This is unlikely. Persons subject to the lower rates simply cannot afford to relax their efforts. Occasionally one might hear of persons refusing to work overtime because of high marginal tax rates. But this is not a common occurrence. In fact, the personal income tax, say below the 50 per cent rate, might even encourage some taxpayers to work harder in order to compensate for the share of their income which goes to the government.

But what about taxpayers in the 70, 80, or 90 per cent brackets? In this instance the Treasury receives an even larger slice of each additional dollar of income than the taxpayer himself. Strangely enough, even in this income group the personal income tax does not seem to detract greatly from the willingness to work. We know this from a 1953 study by the Harvard University Graduate School of Business Administration. This study based its finding on extensive interviews with high-income executives. It reveals that money is only one of many incentives to work. Perhaps more important is

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the human drive for accomplishment, for doing a good job, for power and prestige. Men are motivated by a sense of loyalty to an organization, its staff and its objectives. It is doubtful whether high tax rates deprive our economy of the services of its most capable business leaders.

Use of legal devices

The Harvard study revealed another interesting finding. Few taxpayers actually pay the peak rate of 91 per cent or anywhere near that amount. By means of various legal devices, top executives manage to keep their tax rates down to an average of about 50 per cent. These means include purchasing tax-exempt state and legal bonds; investing for capital gains, which after six months are taxable at a maximum of 25 per cent; taking advantage of depletion allowances granted to developers of oil, gas or mineral properties; and forming family partnerships and trusts to spread income among several people. There are also expense accounts, deferred compensation plans and stock options. It has been estimated that if all the rates in excess of 50 per cent were actually reduced to 50 per cent, the Treasury would lose less than two billion dollars a year in revenue.

Progressive taxes on personal incomes do not discourage hard

work. But their effect on incentives to invest are harder to appraise. While wealthy persons contribute relatively little, as a class, to total tax revenues (primarily because of the very large size of our middle class), they do contribute significantly to the flow of investment funds.

Do our tax laws discourage risk-taking? That is, do they affect the willingness of persons to take risks with their investable funds? Consider the following situation:

Mr. A invests in a new and venturesome enterprise. It turns out, however, that the business is not successful. It suffers sizable losses for several years, but since Mr. A has no income against which to offset these losses, he must bear them himself. Had Mr. A been more successful, the government would have been his partner. As a result of this "heads-I-win-tails-you-lose" philosophy of taxation, Mr. A might well think twice before embarking on this risky investment.

Consider another situation. Mr. A, our venturesome investor, realizes an investment income of 300,000 dollars during one year, but nothing during the next two years. Mr. B. on the other hand, who prefers the safe, conservative investment approach, realizes a return of 100,000 dollars during each of three years. If they are

both married, taxes will take 222,000 dollars from Mr. A, leaving him with only 78,000 dollars. Mr. B, on the other hand, pays 144,000 dollars.

Risk-taking discouraged

By taxing risky investments at a higher rate than steady, routine ones, we discourage the vigorous exploration of new ways of doing things. Instead of risking fortunes in new enterprises, both investors and investments tend to seek safety. Mr. A's investment funds are likely to flow into the safe haven of old, well-established companies. Mr. A himself is likely to become the salaried employee of a prosperous company rather than the owner of his own enterprise.

It is true that Mr. A might be encouraged to put his funds into risky but promising investments in order to realize lower-taxed capital gains. Nevertheless, on balance it would seem that our tax laws now tip the scale against the small and speculative entrepreneur.

Since tax rates above 50 per cent contribute relatively little to the Treasury's total income, it would be wise to reduce these rates gradually, perhaps in recession years, to the 50 per cent level. In this way we would encourage venture capital and remove the premium now placed on

the tax avoidance schemes which make the above-50 per cent rates applicable only to those who lack the imagination and the opportunity to take advantage of them.

When the corporation tax came into being in 1909, no one dreamed that it would ever play an important role as a producer of revenue. It was then a one per cent levy "on the privilege of doing business."

Today, corporations must pay 30 per cent on the first 25,000 dollars of income, and 52 per cent on any excess. It is estimated that more than 80 per cent of corporate income is taxed at 50 per cent, or higher. The corporate tax enjoys political popularity because it brings in a great deal of money while making relatively few voters angry.

The major shortcoming of the corporate tax is that it leads to a double taxation of dividends. First the corporation pays a tax on its net earnings (although some of this tax might be passed on in higher prices); then the stockholder must pay a tax on the dividends disbursed to him. This double taxation gives corporations an incentive to finance their expansion either by plowing back earnings or by incurring debt.

Retained earnings escape the double taxation of dividends since only distributed earnings become taxable to the stockholder.

During the postwar period, more than twice as much venture capital has been furnished by the retention of earnings than by the capital markets. The effect of relying heavily upon internally generated funds to finance business expansion is that existing and large firms are favored to the detriment of small and newer companies. Capital is allocated not so much by the market place as by past patterns of investment.

A stacked deck

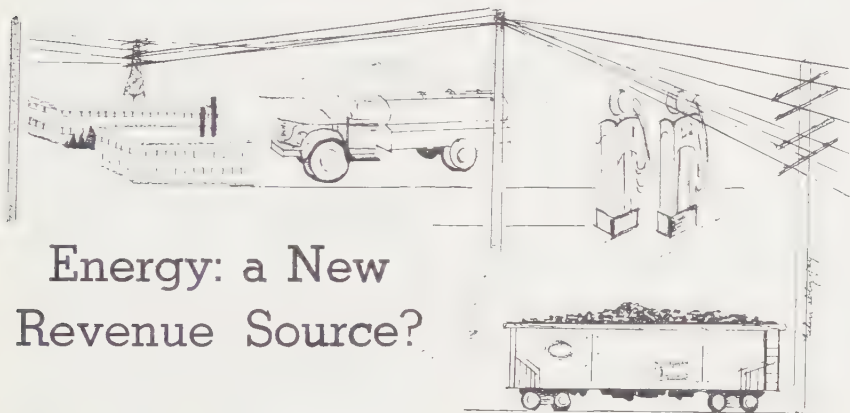
Finally, the double taxation of dividends induces corporations to rely on debt rather than stock financing. Interest on bonds is a tax-deductible item for corporations. This means that a corporation in the 50 per cent tax bracket needs only half as much in pretax earnings to pay interest as to pay an equal amount in dividends. The result is to give a competitive edge to corporations with a heavy debt burden. A new or small corporation, established to exploit a new idea, finds the cards stacked against it. It has no record of earnings to secure the debt, nor can it afford to burden itself with fixed charges and definite maturity dates. Again our tax laws discourage new enterprise and risky ventures.

To reduce the tax discrimination against new and small businesses, President Eisenhower has

advocated legislation to cut to 20 per cent the present 30 per cent levy on a corporation's first 25,000 dollars of income; to permit corporations with only a few stockholders the option of being taxed as a partnership, thus avoiding the double taxation of dividends; and to allow corporations to accelerate their depreciation on used equipment up to 50,000 dollars a year. It is estimated that these recommendations would now cost the Treasury no more than 600 million dollars a year.

Are we taxing away incentives? To judge by our rising standard of living in recent years the answer must be "No." But the prosperity of the postwar period may in fact be obscuring the real impact of taxes on incentives. The time may come when the effects of our tax system become all too clear: when we will have too few innovators and too little venture capital; when risk-taking becomes the province solely of corporations large enough to plow back earnings and prosperous enough to borrow; when effective competition will represent a phase of history; when greater value is placed on steady routine than on venturesome spirit. Even within the budgetary needs of the Treasury we can move gradually toward a tax system which encourages the taking of risks—and therefore the growth of our economy. ■

A French businessman proposes taxes on coal, electricity, oil, gas and gasoline to replace income and other forms of direct taxation



Energy: a New Revenue Source?

TAXPAYERS in the United States grouse and groan about their taxes, but they fork over the money when the time comes. French taxpayers spend most of their time, according to one critic, trying to evade one or all of their 375 different taxes. At the end of the year, the French government estimates, at least 40 per cent of the tax money due tax collectors has slipped out of their hands.

The widespread taxes, both direct and indirect, have eliminated incentives businessmen need to increase income and, thus, have practically destroyed the very sources of the increased revenues required by the government. The rate of economic growth is being slowed dangerously, since businessmen find it unprofitable to invest and to increase their production beyond

the level of the lowest tax rates.

The chaotic French tax system, of course, is not entirely at fault. Bearing much of the blame is the social and economic turmoil brought about by two world wars fought on France's soil and the impossibility of the many French governments since then to adhere to a continuous and constructive economic policy.

The tax system before World War I did not arise from any coherent policies either. It was inefficient and unwieldy to begin with and worsened after adoption of the income tax in 1917.

Widespread opposition to the income tax resulted in the application of the tax on a partial basis. Today, French income tax collections amount to about 140 million dollars on those incomes above 12

thousand dollars a year. Considering that the government's budget is some 12 billion dollars a year out of a national income of some 48 billion dollars, the amount of tax collected on incomes is insignificant.

To shore up the crumbling economy, the French government has had to resort to some plain and fancy fiscal juggling. More than half of the budget, for example, goes into subsidies and tax refunds to encourage particular business activities without any regard to their long-range value.

Order out of chaos

No one likes this deplorable situation, but agreement on how to get some order out of the fiscal chaos is hard to reach. The realities of what could happen to the French economy if the chaos is permitted to remain in control, however, drives economists, government officials, businessmen and labor to keep searching for solutions.

One such solution has been offered by Eugene Schueller, a French industrialist who made an intensive study of economics in order to get at the root of France's troubles. He proposed a tax on "energy" to replace all personal, industrial and commercial income taxes.

Everything that produces "energy" would be taxed—coal, elec-

tricity, gas and petroleum products—when consumed. The rate of taxation, according to Schueller, would be fixed in such a way as to minimize violent fluctuations in energy-producing industries. While the energy tax would be high, the cost of the final product for which one or all forms of energy are used would be lower than they are at present because all other taxes on the manufacturing process would be eliminated.

Schueller anticipates a production increase of at least 30 per cent if the energy tax is adopted. This, in turn, would cause a similar increase in wages. With the elimination of industrial and commercial income taxes, he foresees a 20 per cent decrease in prices. The 30 per cent increase in wages plus the 20 per cent cut in prices would produce an over-all 50 per cent increase in the standard of living of the French people, Schueller contends.

In energy-using industries, such as steel, aluminum and cement, the cost of the material would be increased tremendously by the energy tax. But, Schueller maintains, the price to the consumer of the final finished product in which steel, aluminum or cement is used would be lower than it is today.

The cost of a ton of steel used

CHALLENGE staff members prepared this article from stories on the energy tax in French periodicals.

in making locomotives would increase from 35,000 to 55,000 francs, for example. But the cost per ton of the finished locomotive would drop from one million francs, to 900 thousand francs, thanks to the elimination of industrial and commercial income taxes, Schueller estimates.

He sees a number of other immediate benefits. All direct taxes—borne by the actual taxpayer—would be eliminated. This would cut the existing taxes by 50 per cent and completely establish a system of indirect taxes which are passed on to the buyer. Since such taxes usually cannot be evaded, the entire tax can be collected at a large saving in collection costs.

“Exiled” capital

The abolition of 50 per cent of the present taxes would bring about the return of hidden and “exiled” capital and make it possible for the government to float loans for capital expenditures, instead of financing these expenditures by appropriations from tax funds.

The exclusion of income taxes, both personal and commercial, would also eliminate the incentive to pad expense accounts in order to avoid taxes. On the whole, “legal” evasion of taxes would be made impossible.

The energy tax plan has its drawbacks, as well. The price of

fuel and power would soar, probably out of range of some business firms and many individuals. But, Schueller, replies, present taxes have the same effect, even though they are hidden. If present taxes are translated into the energy tax, about 120 francs in tax is paid on one liter (roughly a quart) of gasoline. Under the energy tax, the price of a liter of gasoline would be the manufacturer's price, plus a 60-franc tax (about 17 cents).

The tax cost on other forms of energy would also be half of what is now being paid. In the long run, Schueller maintains, the energy tax would insure much more economical use of the present limited supply of energy. It would also point up the nation's need for more energy and lead to a vast construction program of public power stations, eventually resulting in a lower energy cost and perhaps a lower tax rate.

Schueller's proposal has become the subject of heated debate in France. Schueller himself has been stimulating more discussion by holding meetings all over the country in an effort to win adherents. Even if he does not win sufficient support to bring about the adoption of the energy tax plan, he will have created a greater interest in combating France's chaotic tax system than has been seen for many a moon. ■

Russell C. Harrington

Commissioner of Internal Revenue

The Job of the Tax Collector



Q *Commissioner Harrington, approximately how much will the Internal Revenue Service be collecting in taxes in this current year, and how does that compare with the amount expected to be collected in the coming year?*

A The best way I can answer that is to say that for the fiscal year ending June 30, 1956, the Internal Revenue Service collected a total of approximately 75 billion dollars in all types of taxes. The latest estimate for the year ending June 30, 1957, is that tax collections will total approximately 79 billion dollars.

Q *Does all this money go into the operation of the government?*

A These are the total tax collections, and some part of these collections are in Social Security and other trust fund accounts, so that the total of 79 billion dollars is not all available for the ordinary operating budget of the government. I think that approximately 69 to 70 billion dollars is the amount which will be available for governmental operations.

Q *How many people does it take to administer our tax laws?*

A At present, our entire force numbers approximately 52,000 people.

Q *What proportion of that 75-billion-dollar total cost does IRS require to administer the collection of taxes?*

A In the last fiscal year, the cost or the proportion of the collections

which was spent for the operation of the Service amounted to approximately one half of one per cent of total federal expenditures.

Q For most of us that figure might not be too meaningful. How does that compare to tax services elsewhere? Would you say that it is a relatively economical operation?

A I really can't answer that question because I have no information at hand as to the cost of administering the tax laws of other countries.

Q One problem that IRS has, like most other tax-collecting agencies, is the problem of tax evasion. What proportion of your operating budget, would you say, does IRS spend in tracking down possible tax evasions by individuals or firms?

A We do not have any fine breakdown of the cost. But it is not a terrifically large figure when you consider the over-all tax collections and the some 60 million taxpayers involved. I can answer your question, however, by saying that about 70 per cent of our budget is spent on what we call enforcement activities, and this does not, of course, connote that evasion is present in all of those cases. When we say tax enforcement, we mean the auditing of returns, the hearings which are held in the district and regional offices, the activities of the appellate division and hearings on disputed cases, and so on.

Q To what extent do you think tax evasion, insofar as it is a problem for IRS, is the result of deliberate intent, and to what extent is it the result of ignorance? And how can one draw the line?

A To my mind, evasion is evasion and has to be deliberate.

Q Evasion may be deliberate, but would you draw a distinction between tax evasion and tax avoidance?

A Yes, there is a very sharp distinction. Tax evasion is illegal; tax avoidance is not. In other words, every taxpayer has a right to adjust his affairs so that he minimizes his tax liability. He can avoid the payment of higher taxes by so adjusting his affairs as to make his transactions subject to some lesser tax bracket. We recognize such steps as perfectly legitimate business undertakings.

Q Just how does the Internal Revenue Service go about this tremendous job of collecting taxes? What happens when a new law is passed?

A The technicians of the Service study it and draft regulations which

are, in effect, the Service's interpretation of the intent and application of the law to specific situations. These regulations are carefully reviewed in our technical department and are then sent to the Treasury where they are studied by their legislative and legal departments. When they have been reviewed by these groups, and their views are consolidated and checked with those of the Service, the regulations are published in tentative form in the Federal Register.

Functions of IRS and the Treasury Department

Q *Why are they tentative?*

A Taxpayers and their representatives are put on notice that these are the proposed regulations. They are given 30 days in which to apply for hearings if there are any matters in the regulations to which they take exception or with which they are not in complete accord. The hearings are held, the views of the interested people are received, recorded and interpreted, and following that the regulations are put in final form and are published as Treasury Department decisions.

Q *What is the difference between the functions of the Internal Revenue Service and the Treasury?*

A The distinction is simply this: the IRS is a branch agency, or, I should say, an agency of the Treasury Department, and its sole responsibility is administering the tax laws as passed by the Congress. The Treasury Department, on the other hand, has the responsibility for making tax policies in accordance with the administration's policy. It prepares proposed legislation and appears at hearings before the Congress to explain its position on matters of tax policy. The Internal Revenue Service has nothing whatsoever to do with making tax policy. It merely draws up regulations to administer the law.

Q *It must be a rather tough job to devise comprehensive regulations which take care of every possible eventuality. What happens, however, when taxpayers disagree with IRS regulations?*

A We have a number of situations where the taxpayers disagree with the position taken by the Service, and these cases usually end up in the Tax Court of the United States or in a District Court, depending upon the circumstances. The decision of the Court is then reviewed by

the Internal Revenue Service, and a decision is made by the Commissioner's Office as to whether the Service will go along with the Court's interpretation or whether it will await another case in another jurisdiction in order to make sure that the revenues are adequately protected.

Q *How many such cases does IRS have in a year?*

A The number of cases going into the courts is infinitesimal in proportion to the total number of cases handled each year by the Service.

Q *All this is a fairly long process from the time the tax law is first passed by Congress until the taxpayer finally pays his bill. How long does it generally take IRS to become fully aware of the implications of new tax legislation?*

A That depends entirely on the complexity of the particular statute. Some of the statutes are relatively simple, and not much time is required to become thoroughly familiar with them. In some of the more complex statutes, it takes a longer time for the Service to acquire the knowledge. This knowledge is gained from actual application of the law and, in some cases, as has been pointed out, from court decisions.

Q *For most individuals, paying taxes is still a fairly complicated affair. Is there any way of simplifying tax procedures?*

A The Service has a group of technicians who spend most of their time attempting to simplify tax procedures, particularly the actual tax forms. It should be borne in mind that the tax form which many people think is complicated is necessarily so because the law itself is complicated, made that way by Congress in its effort to apply equity in the tax laws. It should also be remembered that we live in a complicated society, and we have to put up with the complexities and the complications accordingly. The staff of the Service, which has this matter in hand, is seeking constantly to improve and simplify the tax form, and considerable progress has been made.

Q *What has been done?*

A This year for the first time the instructions which accompany the individual income tax returns for 1956 are quite complete and understandable, and the instructions are keyed to match specific lines on

the tax return itself. For example, if a taxpayer looks at line 10, he can go to the instructions and find, in the corresponding line 10, just exactly what item to record there and how the amount is to be determined.

Q *How well is the present system working?*

A Very well, considering that the United States system of taxation is primarily a system of voluntary compliance on the part of taxpayers. Most of the taxpayers, in fact pretty close to 98 or 99 per cent of them, prepare their returns each year and figure the amount of tax they owe and send it in.

Q *And how about the efficiency of the system?*

A As for the efficiency of the tax system, the only criterion that I think can measure it is the ability of the Service to render adequate service to taxpayers by promptly handling their accounts and complaints and establishing an atmosphere which the taxpayers will feel is conducive to a fair treatment. We believe that the taxpayer should be treated absolutely fairly, and it is the responsibility of the Service to do this while at the same time keeping our pledge to adequately protect the revenues of the government.

Q *To what extent can IRS be conducted like the auditing bureau of a private company?*

A IRS is a big business, and the business principles which apply to any big business would apply equally well in the case of the Revenue Service.

The important point is to keep accurate records

Q *What do you think most of us can do during the year to prepare for the struggle with our income taxes each April 15?*

A The point we always stress is the keeping of good records. I'm afraid that many of our citizens do not give much thought to their income tax return until filing is upon them. Personally, it is my feeling that return filing really shouldn't require too much of a "struggle." We have done our best to simplify the return forms and instructions, and we like to believe that return filing is a fairly simple process when you have good records.

Q *What is IRS doing to assist taxpayers?*

A We are taking long steps forward in trying to educate the public and to give people information which will make it easier for them to comply with the tax laws and, thereby, also increase our efficiency. For example, each year we publish a booklet called *Your Federal Income Tax*. We sell hundreds of thousands of copies of this booklet which explains in nontechnical language the various provisions of the tax laws and how the individual taxpayer can comply with them.

Q *Does IRS offer assistance to small businessmen?*

A We have recently issued a pamphlet called *Tax Guide For Small Business* which explains to the small businessman his responsibilities in the preparation, filing and paying of federal taxes and how to handle special situations which are peculiar to some of these small businesses. In addition to that, we have issued a guide for farmers which explains in some detail, and in as nontechnical language as we can devise, how the farmers should keep their records, what records to keep, and how to use the information in those records to prepare their income tax returns.

Q *We have heard that IRS is now teaching youngsters the fundamentals of income tax payments. Are you doing this because you anticipate that Congress will next tax teen-agers?*

A Oh, no. We have prepared courses for high school and parochial school students, and more than 90 per cent of the schools throughout the country are using these courses and making them a part of their regular curricula so that the children get a feel of the federal income tax during their school days. I might mention that this same course is also being used in many of our colleges and universities. This is part of our vast educational program, all of which is intended to make the income tax more understandable to more people.

Q *IRS cannot do away with taxes, but it can make taxpaying more convenient and more agreeable than it is now. Can it do more?*

A I think so. The Service can contribute to an efficient economy and to the general welfare of the people by establishing and maintaining a policy of fair, impartial and adequate enforcement of the tax laws.

Q *Thank you, Commissioner Harrington.* ■



• *Everyday Economics*

MANY banks make the point that interest on savings accounts, compounded quarterly or monthly, provides greater earnings than does interest compounded semiannually. True enough, but in actual dollars and cents it comes to less than you might expect. At the end of five years, five hundred dollars at three per cent interest compounded semiannually will have earned \$80.27; compounded quarterly, \$80.59; and monthly, \$80.81.

For the record



YOUR tax records should be kept for six years after the due date for filing your return for the year in question, or at least six years from whatever date you filed. A complete set of accurate records will assure you of not losing deductions for losses and expenses. Cash receipts can be kept in your check book or entered in a cash book. Keep written evidence (whether check, bill, receipt or en-

try) for every expense, especially for travel and entertaining expenses. Also keep cancelled checks and bills.

Jobs for refugees



THE public employment office of your own state can now supply you with forms to enable you to offer a job to a Hungarian refugee. Issued by the Bureau of Employment Security, they include questions as to whether a knowledge of English is required, the type of work offered and the amount of pay.

Sound conditioning



SOME recent tests made by the Carpet Institute have shown that carpeting provides effective sound absorption for both sounds traveling through the air and impact noise, i.e., vibrations in the structure of a building caused by such blows as heels pounding on floors and

chairs scraping. The tests showed that carpeting absorbs about ten times as much airborne noise as other types of floors or floor coverings. The greater the depth and density of the pile, the greater the absorption, it was found, and underlays increase the absorption. Yarn weight makes no appreciable difference, and wool, cotton, nylon and rayon absorbed equally well. Since quiet makes for comfort and also greater efficiency in both home and office, carpeting performs an important function.

Keeping posted



A DESK aid that will prove invaluable, especially for secretaries, is a booklet that explains how to get a letter back after it has been mailed, the different kinds of mail, and the services offered by our post office. Called *Tips on Your Post Office*, it is available for 20 cents from T. Reed, Sales Dept., The William-Frederick Press, 313 West 35th St., New York 1, N. Y.

Taxing dates



ON MARCH 15, corporations and those unincorporated businesses that elect to be taxed as corporations file the 1956 tax return on form 1120, and pay the first installment. Employers deposit income

and Social Security taxes withheld in February, if the amount exceeds 100 dollars. Farmers deposit all undeposited Social Security taxes on wages paid employees in the 1957 period, if the amount is over 100 dollars. And tax-exempt organizations with business income, file the 1956 return on form 990-T, and pay the first installment, 50 per cent of the tax.

Splash away

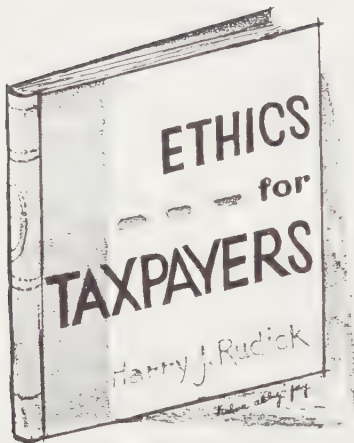


TO PROTECT windows, doorknobs and other such surfaces when painting, coat them with soap-suds. The paint splatters will wash away with the suds when the job is done.

Cool, calm and collected



THE American Heart Association has suggested six resolutions for the estimated five million Americans who suffer from high blood pressure: see your doctor regularly and follow his instructions; avoid worry and emotional stress as much as possible; get plenty of sleep, taking short naps during the day when feasible; rest *before* becoming tired; take mild exercise and avoid competitive sports in which it is difficult to quit when tired; and keep your weight normal.—G. M. S.



WHAT is the difference between a tax avoider and a tax cheater? The answer to this modern-day riddle does not lie in the subtleties of distinguishing between a tax avoider and a tax evader, which some cynic has described: a tax avoider is someone who succeeds; a tax evader is one who fails.

My answer is that avoidance is every conscious attempt, successful or unsuccessful, to prevent or reduce tax liability by taking advantage of some provision or lack of provision in the law. This definition excludes fraud or concealment and presupposes the existence of alternatives, one of which will result in a lesser tax than the other.

If, for example, a U. S. citizen who earns his living by writing moves outside the country to write,

he can be considered a tax avoider if he is motivated by the desire to avoid taxes. If he moved out to be in a more healthful climate, he would not be considered a tax avoider.

Cheating is something else again. It is deliberate concealment of income, fraud. Without a doubt, there is a considerable amount of income tax cheating today; there probably always has been. And while there is no way to measure just how much, I would guess that the revenue lost as a result of premeditated tax deceit is greater than at any other time in our history, despite the fact that we have a withholding tax on wages. Naturally, the very high rates of tax—the minimum is 20 per cent and the maximum 91 per cent—have spurred tax chicanery as well as tax avoidance.

The tax cheater

Thus, we have waiters and taxi drivers who fail to report all their tips, doctors and others who do not deposit or report all the fees they receive, merchants who do not deposit or report all the sales they make, individuals who claim deductions for imaginary contributions and nonexistent dependents, people who do not report interest on savings accounts or bond coupons, and so on.

Few of these tax cheaters are high-bracket taxpayers. To them,

therefore, the concealed tax liability may be considered picayune, small enough to be reconciled with their conscience. Perhaps the concealment is also justified by the belief that Congress has offered to entrepreneurs and certain high-bracket taxpayers legitimate methods of avoidance.

Whatever the justification or rationalization, tax cheating can be considered immoral and unethical, and, if bad enough, a crime against society. The ethics of tax avoidance, on the other hand, are not as clear-cut. Macaulay said of Byron's poetry that it embodied a system of ethics in which the first two commandments were "Hate your neighbor, and love your neighbor's wife." The average tax avoider or would-be avoider loves his country, but he dislikes its tax collectors.

He says, "I want to pay my just tax. The government needs money, and I want the government to get every dollar I owe it. But at the same time I have to look out for myself, and if there is any legal way in which I can cut down my tax bill, I want to take advantage of it." He is a patriot, but a canny one.

The loss of revenue from tax avoidance is only superficial. The

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government has to exist, and it must raise a certain amount of money to do so. In essence, the aggregate tax is not cut down by any particular act of avoidance. If one taxpayer pays less than his share, the deficit will be made up by higher rates, or in some other way, and it all will be spread lightly among the rest of the taxpaying population.

The question of how far a man is morally entitled to go to cut down his income tax liability is troublesome. But I have finally reached the conclusion that when Congress consciously condones, indeed encourages, tax avoidance, the taxpayer has every right, moral as well as legal, to avail himself of the Congressional bounty.

Burden of criticism

I do not say he is a fool if he does not take advantage of the opportunity; but I do say that he is not to be censured if he does. The burden of criticism must be left at the doorstep of the legislature.

But where Congress does not knowingly condone avoidance, the problem becomes more subtle and more difficult. Suppose a taxpayer believes that the fiscal and economic policies of the administration are bringing the country to ruin. Suppose he feels that the government has treated him unfairly or that the law is unjust.

Do any of these factors justify his avoidance of tax?

For example, suppose a taxpayer wishes to sell his business to his brother. If the sale results in a real loss to the taxpayer, the statute which denies the taking of losses on property sold to parents, brothers and sisters, and descendants, but not in-laws, will bar the loss even though the transaction is free from any tax-avoidance taint. Is he not justified in making the sale to his brother's wife? In such situations the problem becomes almost entirely subjective, and in seeking an answer it is fairer to ask, "What would you do if you were in his shoes?" rather than, "What should he do?"

If the Congress chooses specifically to exempt from tax the interest on state and municipal bonds, an immunity for which there is doubtful justification, the rich man does not play the rogue by investing in such bonds. Rather, it is the legislature which plays the fool.

If a corporation, owning a warehouse for which it paid an inflated price, sells the property at a loss in a bona fide sale and then leases it back under a bona fide lease to cut down the income tax which the corporation must currently pay, are the directors of the corporation to be adversely criticized? They are performing their duty to their stockholders, pro-

ducing for them the maximum return legally permissible on the stockholders' investment. Should they be taken to task for it?

Suppose an individual who has decided to make a contribution to a charitable institution makes it in property which has enhanced in value, rather than in cash, and thus escapes tax on the enhancement. Is he to be censured?

The answers to some, but not all, of these questions seem reasonably clear. In general, it seems to me that there is nothing ethically wrong in avoiding tax when the legislature with its eyes open has offered the means of such avoidance.

But where the offer is unintentional, the justification for avoidance is not so easily found, nor is the attempt often successful. Where the avoidance is an attempt to overcome an inequitable statute, one which is unduly harsh, the avoidance is easily vindicated. But where there are no such extenuating circumstances, exoneration becomes difficult.

Benefits and loopholes

Congress, despite prodding by the Treasury, has not acted with much alacrity in closing up loopholes. Recently the House Ways and Means Committee received a report listing 28 unintended benefits and loopholes offered taxpayers by the 1954 Internal Revenue

Code. It is virtually certain that not all of the loopholes called to the Committee's attention will be stopped up by any bill reported out of Committee; and if precedent is a guide, the Committee's somewhat diluted bill will be further watered down after it runs the gamut of the Senate Finance Committee.

Of the methods of avoiding tax which are openly encouraged by the statute, the three which probably involve the greatest loss of revenue protect investment income rather than earned income. The first of these exempts income from investment in state and municipal bonds; the second, investment which yields capital gain—subject to a maximum tax of 25 per cent—rather than ordinary income; and the third, investment in mineral deposits, notably oil wells, and other properties for which the so-called “percentage depletion” is allowed as a deduction.

An appealing case

At the present time, an appealing case can be made for the continued exemption of the interest on state and municipal bonds because of the compelling need for local improvements, principally schools. The financing cost of such improvements would be increased if the exemption is taken away. However, in the long run, it is difficult to justify the immunity.

It materially reduces federal tax revenue and thus prevents lower rates than might otherwise be possible. It arouses a sense of inequity in taxpayers who cannot take advantage of the immunity. To my mind, these factors certainly justify the higher borrowing costs which local governments would have to pay.

Capital gains and the relatively low rate applicable to such gains, are probably a reflection of the fact that Congress really feels that the higher income tax rates are too high, both from the viewpoint of equity and economic growth, and that it is therefore essential to provide an escape valve. Congress has been persuaded to gradually expand the concept of capital gains to include many types of recurring income which are originally not thought of as capital gain: gains from the cutting of timber, from the sale of certain livestock, from the sale of depreciable property, income from patents. Once embedded in the law, such favors are exceedingly difficult to remove. The result is that other taxpayers seeking equality can only get it by coming under the capital gains umbrella; hence the umbrella has to continually be made bigger and the discrimination against those who can't be protected by it becomes larger and larger.

The third of the major loop-

holes, percentage depletion, is not generally known by the average taxpayer, but it is of vital importance to many high-bracket taxpayers, particularly those in the oil producing states. Percentage depletion is also permitted on all other minerals and even such virtually inexhaustible deposits as clay, stone, etc., although at smaller rates. Under the percentage depletion allowance, the recipient of income from an oil or gas well is allowed to deduct 27.5 per cent of the income. He is allowed to do this year after year even after he has been permitted to deduct the entire cost of the property. It is one thing to allow a taxpayer to recoup his capital, but to allow him to escape tax on millions of dollars in excess of his capital is something else.

With so many legal avenues open, tax avoidance is hardly a reflection on the tax avoider. People being what they are, they will pay no more than they legally owe, and I believe there is nothing ethically or morally reprehensible in this. Rather, the fault is to be traced to government officials and legislators who continue to advocate and adopt a tax rate progression which is so steep and reaches such high levels that they find it necessary to resort to special tax concessions to make the economy more viable than would be possible were there no relief from the

highest rates. I suspect this attitude of our tax policy makers is due to a mistaken apprehension that the reduction of the highest rates without a proportionate reduction of the lowest rates is politically inexpedient. Yet most voters would not criticize a legislator who voted for a maximum rate of say 60 per cent, particularly when higher rates do not produce a significant amount of revenue and serve as justification for escape valves.

There are other measures which, if adopted, would materially reduce tax cheating. For one thing, we could require savings banks and other institutions which credit or disburse interest income to withhold tax on such income. Similarly, corporations distributing dividend income could be required to withhold tax on such distributions. Taxpayers who receive large amounts of income in the form of cash could be subjected to more careful scrutiny. Violations of the law could also be prosecuted more vigorously.

Ours is largely a "system of taxation by confession," as the late Robert H. Jackson, Justice of the Supreme Court, pointed out. Once the notion becomes prevalent that tax avoidance is a slight, excusable sin—and this notion may well spread if we go on giving special favors to certain groups—the system is in dire danger. ■

Social Security

by Earl E. Muntz

{ tax
plus
insurance

THE EMERGENCE of compulsory social insurance and welfare programs has created a special category of taxes—"contributions" or premiums which are imposed quite generally upon employers and, to a much lesser extent, upon employees, the potential beneficiaries. The humane objective of these compulsory taxes and quasi-taxes often obscures the economic burdens resulting from this new way of having society provide security which, in the past, was provided solely by the individual.

There are today four main kinds of compulsory social insurance and welfare programs: workmen's compensation, unemployment insurance, health insurance and Old Age and Survivors Insurance. These programs are financed through taxes, contributions and premiums of various kinds. Let us take a look at the principles behind these programs and the taxes levied to finance them.

Workmen's compensation laws. Such laws are found in every state and territory in the United States, in addition to the Federal Employer's Liability Act. Under both the state and federal workmen's compensation acts, workmen injured on the job or contracting occupational diseases in the course of covered employment are entitled to an indemnity regardless of fault. The idea behind the law is that work accidents and illnesses are a legitimate part of the cost of production and, therefore, must be borne directly by employers subject to the law.

The employer's liability to his injured employee is twofold: he must pay for the medical and hospital expenses arising from the injury and he must provide cash compensation for time lost on the job. Except in seven states which compel employers to insure in the state's own monopolistic fund, the employer can buy insurance from

any authorized carrier, or resort to self-insurance. In any case, this is a compulsory cost imposed by law to cover the employer's liability, and the net effect is the same as a specific tax.

"Semi-tax" costs

It is estimated that four out of five civilian wage and salaried workers are currently covered under workmen's compensation laws. In 1955, covered payrolls amounted to more than 158 billion dollars and protected some 40 million workers. Benefit outlays were more than 920 million dollars, of which about one-third went for medical and hospitalization costs, and the balance for cash compensation.

Current trends suggest that these "semi-tax" costs of workmen's compensation may be expected to rise within the next few years. For one thing, cash benefit payments have not kept pace with wages. As a result, it has become impossible to maintain cash benefits at two-thirds of weekly wages, which is generally accepted as a suitable ratio. Medical and hospital costs are also rising, and state laws are increasingly liberal as to duration and scope of benefits. Finally, a greater coverage of the working force is to be expected as exclusions because of size of firm are reduced or eliminated. On the other hand, certain factors

may retard the growth of such expenses. These are: the enforcement of legal and the adoption of voluntary safety measures; employers' efforts to combat accidents as a means of lowering insurance rates; and better rehabilitation, which has up to now been disappointingly ineffective.

Unemployment insurance. The severity of the depression of the 1930s brought forth the Social Security Act of 1935 which established a state-federal unemployment insurance system, to be supported by payroll taxes on employers, with such additional taxes as the state might impose.

Safeguards for payment

Under this law, pressure was exerted upon the individual states to pass unemployment insurance laws by a three per cent federal tax on the payrolls of employers. Up to 90 per cent of this tax might be credited to the taxpayer in a state—if the state enacted an unemployment insurance law containing certain safeguards for payment of benefits. The state could thus levy a tax of 2.7 per cent on covered employers' payrolls to build up necessary reserves.

The federal tax is described in the law as an "excise" tax. This

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classification gives a somewhat different twist to the term "excise" than the usual concept of a tax on commodities, legal documents, securities and theater admissions. For, this is a tax *on the act of paying wages*.

A cumulative profit

The internal revenue payroll tax of three-tenths of one per cent, collected directly by the federal government from each employer, was intended to cover the costs of administering the individual state systems of unemployment insurance. The tax is a part of the government's general revenue. Expenditures for administration are budgeted annually and appropriated by Congress. But appropriations have never equalled the amount of the taxes collected, leaving the federal government with a cumulative "profit" which, by the fiscal year 1954-1955, had reached 1.1 billion dollars. The possibility of future profits has now been eliminated by a federal law which provides that any excess of tax collections over administrative expenses shall be used to maintain a permanent reserve of 200 million dollars in the federal unemployment account, from which loans may be made to states with depleted reserves. Any excess is to be returned to the accounts of the individual states for benefit payments or administrative costs.

In the beginning, "contributions" or taxes collected by the states were generally 2.7 per cent—the excused portion of the federal tax. However, experience rating has made it possible for the states to reduce this rate gradually, depending upon the stability of the employer's employment record. His contributions may thus range from a fraction of one per cent (even zero in some states) to 2.7 per cent, or more, if provided in the state law. In any case, all state unemployment insurance taxes must be deposited in the Federal Unemployment Trust Fund and invested by the Secretary of the Treasury in interest bearing obligations of the United States, or guaranteed by the United States.

Inasmuch as state unemployment insurance taxes are tied to experience rating, costs for individual employers will rise or fall with the amount of unemployment in their firm. Over-all taxes, however, will increase in proportion to increases in the labor force. Since generally adequate state reserves have already been built up, and since the unemployment insurance systems operate on a pay-as-you-go basis, there is little chance of overtaxation building up huge, unnecessary reserves. Of course, if collectively bargained supplementary unemployment compensation programs and political pressures

were to convert the state systems into a sort of state-supported guaranteed annual wage system applicable to all workers, then the tax costs would rise tremendously.

Old Age and Survivors Insurance. The Social Security Act of 1935 also provided for a Federal Old Age and Survivors Insurance system to be supported by contributory taxes from both employers and employees. With the inclusion in recent years of self-employed persons, professional workers, farmers and other new categories, this program now covers more than 92 per cent of the labor force and, together with the railroad retirement program, embraces some 75 million insured persons.

Benefits have been increasing rapidly due to the new categories of beneficiaries, the expanded coverage, the aging of those covered in time past, and the liberalization of benefits. Old Age and Survivors Insurance benefit payments for the fiscal year 1955-1956 totaled 5,361,000,000 dollars.

This enormous system has been built upon the contributory taxes of employers and employees right from the beginning. The employer's tax is described in the law as an excise tax; the employee's as an income tax.

The employer's excise tax on the act of paying wages is treated as a cost of carrying on business, and is largely shifted to the con-

suming public by incorporation into prices. The employee's wage tax is definitely regressive since it is limited to incomes of not more than 4,200 dollars per year. Above that, the rate is the same for all, regardless of the size of income. Further, it is a tax on gross income without limited personal exemption or deductions for dependents. Obviously, the social security income tax bears heaviest upon low income people who can least afford the decrease in take-home pay. However, since this employee's income tax is assumed to provide specific old age benefits for him, it might be likened to premiums for insurance where the burden would fall quite naturally upon the potential recipient.

Nonoccupational disability

Compulsory sickness insurance. Such insurance came by way of an extension of unemployment insurance concepts. While unemployment insurance benefits are limited to those able and willing to work, compulsory sickness insurance seeks to provide disability to persons involuntarily unemployed because of some nonoccupational disability. Rhode Island, California, New Jersey and New York have adopted such insurance, and cash sickness benefits were also provided by amendments to the Railroad Retirement and Unemployment Insurance Acts in 1946. The

Rhode Island, California, New Jersey and railroad disability acts are tied in with unemployment insurance, using the same employment qualifications, benefits, duration and administration. The New York law, on the other hand, is linked to workmen's compensation and administered by the Workmen's Compensation Board. Altogether about 11 million workers are covered by disability insurance under state law and one million by the railroad law.

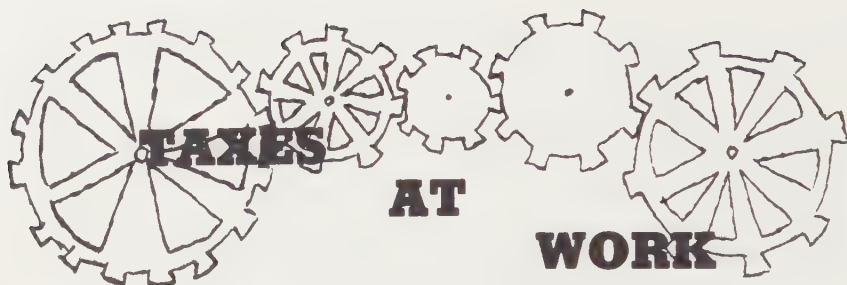
Rhode Island, California and New Jersey were among the few states which imposed an unemployment insurance tax upon employees as well as employers. When it became apparent that the employers' tax was sufficient to provide benefits, Rhode Island and California diverted most of the employees' unemployment tax to set up a reserve for a compulsory disability insurance system. Under this system, neither employers nor the state make any contribution. New Jersey also shifted most of the employees' tax to disability insurance, but introduced the new principle that employers must bear part of the costs of sickness or accidents not in any way connected with the job.

Voluntary plans may be substituted for the state program by employers in California and New Jersey, provided such plans are approved by a majority of the em-

ployees, that minimum provisions for eligibility and benefits are equal to those provided by the state system, and that the employee is not required to contribute more than under the state plan. In both states the employer may use the state plan, self-insurance, or insurance through a private company.

Under the railroad disability program, payments by employer and employee are obviously taxes based upon the payroll and wages received. The tax nature of employer payments to the state fund in New Jersey is also apparent. All employee payments in Rhode Island, California and New Jersey bear definite tax aspects. However, if California or New Jersey employers, with the approval of a majority of their employees, set up voluntary contributory plans, the "contributions" outwardly seem to lose their tax appearance. In New York the tax aspect is hidden, for there is no tax collected by state authority, but the employer's liability for disability payments is fixed by law. The compulsory nature of these contributions likens them to taxes.

Altogether, compulsory taxes or premiums for social insurance took 11,135,872,000 dollars out of payrolls and wages for 1955. There is little reason to expect a slowdown in demands for increased social insurance over the next few years. ■



by Elmer M. Harmon

They help society attain the goals of high employment, economic stability, national security and social welfare

ADD THE revenue from all federal taxes to the money collected by state and municipal governments across the country and you will find that the total annual yield is just about 100 billion dollars. If that amount of money—equal to about one-third of our national income—were divided evenly among the population, every man, woman and child in the country, including that week-old baby next door, would get a check for more than 600 dollars.

It should be readily apparent that raising such enormously large sums of money must inevitably affect society strongly. Equally apparent is the opportunity—indeed, it is a challenge—that our society has to arrange tax measures in such a way as to promote the broad social objectives of price stability, high employment, adequate defense and democratic ideals.

In our era, defense appropriations have accounted for between 42 and 60 per cent of total federal spending since 1951. But there is more to arming ourselves for a possible war than just building up an arsenal of hydrogen bombs and jet planes. Certain industries, essential in time of war, must not be allowed to atrophy and die for lack of business in time of peace. Tariffs, subsidies and tax concessions are employed by the government to keep these industries alive.

Tariffs, for example, have been used to protect the domestic watch-making industry from foreign competition. President Eisenhower, in upholding the Tariff Commission's recommendation for an increase in the rate on incoming watch movements, declared that national defense considerations required the retention of watch-

making skills and precision operations in the United States. Subsidies have sustained the merchant marine and such industries as aircraft and synthetic rubber since the end of World War II. Tax concessions, particularly accelerated depreciation allowances, were used throughout the Korean war and its aftermath to stimulate production of war materials.

Taxes have also contributed to manpower needs for defense. Taxes supporting public education and certain health services help to build manpower reserves by lowering the incidence of illiteracy, malnutrition and poor physical condition among the young men and women of our nation.

Taxes, at times, are utilized for regulatory purposes as well as to yield a substantial amount of revenue. Such a tax was the Saladin tithe which was imposed during the Third Crusade (1189-1192) on all who failed to "take the cross." It both encouraged "enlistments" and provided revenue to finance the crusade.

If the objective of a tax is to eliminate an activity completely, obviously no tax revenue will be forthcoming; nor is it desired. In an effort to reform a chaotic currency supply, Congress, after the Civil War, permanently elimi-

nated state bank notes by placing a tax of 10 per cent per year on the face value of all state bank notes outstanding. In 1912, phosphorous poisoning in the match-making industry was wiped out by the simple expedient of placing a tax of two cents per hundred on the manufacture of white phosphorous matches. An attempt was made in 1916 and 1918 to discourage the use of child labor by placing a special tax on all products of child labor entering into interstate commerce. Revenue considerations alone would never have produced these taxes.

Perverse effects can sometimes result from taxes engendered by revenue considerations alone. The current three per cent federal excise on freight, imposed during World War II as an emergency measure, is an example. This tax discriminates not only against cheap, bulky goods such as grains, but also against all firms unable to use alternative means of transportation because of their small size or geographic location. By raising transportation costs generally, this tax reduces the number of firms competing in any one area, and reduces the role of the railroads.

Taxes may also be used to supplement government police powers. Our federal government, for example, lacks the authority to forbid the manufacture of opium, marijuana and machine guns. Yet

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virtually prohibitive federal excises attempt to preclude either the manufacture or trading of these items. Nonpayment of the tax leaves the traders open to prosecution for tax evasion. Somewhat analogous is the government's policy of prosecuting the suspected embezzler or racketeer for income tax evasion when only the possession of unreported funds can be proved.

But taxes are of greatest value when they help society realize the potentials of democracy. The essence of any democratic society is the free and active interplay of the wishes of millions of people, each individual an intelligent free agent, each small enough to be powerless by himself, yet strong enough to join in combination with people having common interests.

Not a free agent

The publisher whose very existence is dependent upon only a few advertisers, like the publisher whose existence is dependent only on the whim of a government official, is not a free agent. The minister whose church owes its perpetuation to the benevolence of a single benefactor is not a free agent. Nor are the offspring of the poorest families—not while they are shackled by ignorance.

Tax policy can make a contribution here in three ways. First, taxes may be used to help prevent

the concentration of economic power, which begets concentrations of political power—the antithesis of democracy. Significant tax measures designed to discourage extreme concentration of ownership and wealth are already in the tax statutes: the two per cent tax on intercorporate dividends—dividends received by one corporation from another; the 15 per cent tax on consolidated corporate returns; the federal corporate income tax rates, as well as the marked progression in the personal income and death tax rates.

Second, taxes may be used to help promote equality of economic opportunity. The natural competitive advantage of the wealthy may be partially offset by a redistribution of income through the public economy. Studies indicate that this is exactly what is taking place in the United States.

Perhaps the most complete study to date is John H. Adler's, in *Fiscal Policies and the American Economy*, edited by Kenyon E. Poole. Adler's findings are that the combined effect of the taxes and expenditures of all levels of government in the United States is progressive. The real incomes of the recipients of incomes of less than 1,000 dollars per year is increased an estimated 73 per cent. The real incomes of the recipients of incomes of over 7,500 dollars

per year is decreased an estimated 22 per cent. The real incomes of persons receiving between 1,000 and 7,500 dollars per year are unaffected. Their proportionate share of the goods and services provided by the government is estimated to be equal to the amount of taxes, direct and indirect, that they pay.

Badly eroded tax bases

Third, taxes may also be used to stimulate ownership of homes and other private property. The homeowner, for example, deducts property taxes and interest payments on his mortgage in computing his federal income tax. The tenant, on the other hand, pays a rent which includes the property tax on his lodging as well as a return on his landlord's investment. This favoring of the homeowner over the tenant not only encourages a respect for laws upholding private property but also contributes to fostering the acquisition and construction of homes.

If an even greater equality of wealth and income distribution is desired, one needs only to strengthen existing tax measures. Inasmuch as the income and death tax rates are already steeply progressive, the preferred method would probably be to rebuild what can only be described as badly eroded tax bases.

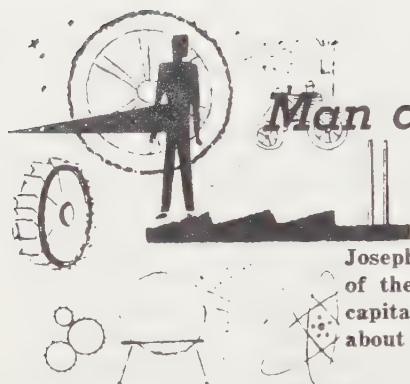
In the field of income taxation a start could be made by eliminating

the preferential treatment accorded capital gains income and the income from municipal securities. Also, the possibility of including as employee income such items as employer contributions to employee pension funds should be re-explored. After all, such items *are* income to employees.

In the field of death taxes, an attack could be made upon the partial tax avoidance that occurs through the use of trusts. In addition, the wholesale exemption from the death taxes of gifts to philanthropic organizations should be reconsidered.

A strong case in equity exists for the enactment of each of these measures whether one is satisfied with the current distribution of wealth and income or not. If the enlarged tax bases result in the collection of too much tax revenue, a reduction in tax rates should not be difficult to achieve.

Many of these proposals, however, are controversial. Nor is the list of possible social goals even approximately exhaustive. But thinking along these lines must be encouraged. Too long has tax policy concerned itself too exclusively with the raising of an adequate amount of revenue. Taxes *do* have important social, economic and political effects, whether we will it or not. It is only sensible that we direct these effects into promoting the kind of society we desire. ■



Man and the Economy

No. XXII

Joseph Schumpeter, although an admirer of the capitalist system, believed capitalism's successes would bring about its eventual decline

"Can capitalism survive? No. I don't think so."—JOSEPH ALOIS SCHUMPETER in *Capitalism, Socialism and Democracy*.

JOSEPH SCHUMPETER, Professor of Economics first at Bonn and then at Harvard, and one-time Minister of Finance in Austria, was one of the most original economists of the 20th century. Although he contributed many ingenious technical refinements to his subject, even economists find these less interesting than his provocative interpretation of capitalism—an interpretation whose pessimism is succinctly illustrated by the quotation at the head of this article. As we shall see, this gloomy prediction was not accompanied by a dislike of capitalism. On the contrary, Schumpeter was an almost unqualified admirer of capitalism and an acute critic of that socialism which, he

feared, would triumph in the end. He did not believe that capitalism was doomed because it was inefficient or unjust. Paradoxically, he believed that capitalism's decline would be brought about by capitalism's great successes.

How did he justify such paradoxical conclusions? According to Schumpeter, the unique element in capitalism is change; and capitalism's glory has been the tremendous improvement in techniques and per capita output (some three per cent a year for perhaps a century in this country) which has accompanied this progress. The central figure in this long-run trend, and also in the shorter-run alternations of prosperity and depression called business cycles, is the entrepreneur. Of businessmen there are many; of entrepreneurs there are very few. For the entrepreneur is a very special sort of person. He is the originator of

new ideas, new techniques and new modes of business organization. The entrepreneur bankrupts old enterprises, forces routine businessmen to reevaluate their activities in order to survive, and substitutes his "innovation," as Schumpeter labeled not only inventions but also new ideas, for older ways of doing business—a process which Schumpeter termed "creative destruction."

Always a small minority, these entrepreneurs tend to cluster at the beginning of expansion. Indeed, it is because of their activity that expansion—first in investment and eventually in consumption—takes place at all. When these new ideas become commonplace through imitation, their impetus wears off, and the economy enters a contraction phase of the business cycle. Recovery can begin once more only when a cluster of new innovations again increases investment and consumption.

Such are the main features of Schumpeter's explanation of the cycle. But the role of the entrepreneur is also central to the long-run trend, for it is only because of his activities that the economy begins every recovery phase from a higher point and reaches a new peak in each cycle. Innovation and only innovation explains that three

per cent increase in annual per capita output, which in thirty-three years doubles the standard of life.

In Schumpeter's romantic world, the hero is the entrepreneur. Like that of most heroes, his life is hard. Misunderstood and ridiculed by conventional businessmen, he scrapes through only by dint of his superior wits. The sort of person Schumpeter had in mind can be suggested by a look at the founders of two industries which have shaped our lives, autos and movies. The men who started the automobile industry in this country — Ford, Durant, Duryea, Chrysler, Knudsen, or Nash—were, none of them, men of great wealth. In their day, their respectable rivals often viewed them as eccentric crackpots. Henry Ford, for example, had an excellent job as chief engineer with an electrical company. But he would persist in tinkering with locomobiles in his back yard until his company, anxious to preserve its dignity, warned him to give up either his auto or his job. Since he was a man with a vision, he relinquished his position. The vision was great, and he trusted it. The conventional businessman, according to Schumpeter, sees no visions; if he did, he would ignore them.

The characteristics of the entrepreneurial type are seen even sharper in the movie industry.

This is the twenty-second article of a series in CHALLENGE dealing with the economic development of man.

Why cannot capitalism continue to change in this way? Do not the many new products around us testify to the continuing activity of entrepreneurs? Schumpeter's answer is depressing. Something has happened to capitalism which blurs and weakens the role of the entrepreneur; and if he is superseded, then capitalism must lose its unique feature and yield with scarcely a whimper to socialism.

Entrepreneurial behavior

The movies were originally a toy which Edison, the inventor, wanted to exploit only in penny arcades. Neither inventors like him nor successful businessmen and financiers saw the possibilities in movies. The men who realized that there was money to be made by showing films to audiences in theaters, audiences composed of people who could not afford the expensive legitimate theater, were of varied background. Adolph Zukor was a tailor. Mack Sennett was an unsuccessful actor. Goldwyn, Selznick and Mayer were all men of humble origin, little interested in the movies as an art form. Against the opposition of the substantial businessmen of their day, they boldly pushed forward a new idea, in a new way, using new modes of doing business. Such is the typical behavior of the entrepreneur, the mainspring of capitalist change.

The major changes which Schumpeter identified in capitalism—all of them by-products of success—are four. First and most important, corporate bureaucracy increasingly replaces the entrepreneur. Invention becomes a *social* process, the result of group research supported and controlled in great laboratories owned by large corporations. Inventions are made to order, and they are introduced according to routine, cost accounting calculations. In a world dominated by the giant company, the bold spirits who disturbed existing arrangements with novel ideas and methods can find no scope today. The salaried employee replaces the entrepreneur, and with the entrepreneur's disappearance the principal distinguishing feature of capitalism also vanishes. The salaried corporate administrator, said Schumpeter, will work just as readily for the state if industry is nationalized. Indeed, he may scarcely know the difference.

Second, successful mature capitalism tends to destroy the small capitalist who is a major element in the strength of the system. As the average size of enterprises increase and their number diminish, the number of people ideologically attached to capitalism grows even smaller. Third—an even more subtle point—capitalism tends to destroy the groups which protect

it. In Schumpeter's opinion, businessmen make poor elected officials. They have performed best when other classes ran the state and left them, unhampered, in the pursuit of profit. The point is clearest in England where all throughout the 19th century the landed aristocracy governed the country while industrial capitalists concentrated on running their businesses. But capitalism destroys just such invaluable groups and when the businessman tries his hand at politics, the consequences are usually disastrous.

Finally, capitalism in its last stages grows rich enough to support in idleness a class with nothing better to do than to criticize. This is the intellectual group, made up of those who make their living by words and in consequence feel a certain lack of useful function. They assuage their resentments by carping criticism.

A private bureaucracy

Thus capitalism, by its very successes, destroys its own future. The large corporation is a monument to *past* innovation, to the ingenious souls who invented, alone, mass production techniques and refined methods of corporate control. These monuments can be administered by much lesser men, men just intelligent enough to follow routine of a high order. This is private bureaucracy. Pub-

lic bureaucracy is only a short step away. The small capitalist, often the most ardent defender of capitalism, disappears and intellectuals by derision and constant criticism weaken the faith of all in capitalism.

How long capitalism can endure, Schumpeter did not explicitly forecast. In his more cheerful moments he spoke vaguely of a generation or two. But the end is certain. "Can capitalism survive? No. I don't think so."

It is interesting to compare this vision of the future of capitalism with that of the Marxists and the secular stagnationists. Marxism predicts capitalist collapse as arising out of capitalist contradictions, above all that between the tremendous capacity of the economy to produce and its limited ability to consume, the result of a very unequal distribution of income. Capitalism from the Marxist point of view is a failure. Schumpeter's vision differed at several key points from Marx's analysis. Capitalism according to him, is *not* a failure. On the contrary, it is so great a success that even people of average ability can administer it effectively. Although capitalism will perish, it is success, not failure, which will prove fatal.

Schumpeter never doubted that capitalism could continue to improve living standards, increase

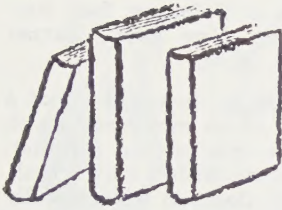
leisure, provide stable high employment and grant to all a fuller measure of material satisfaction. Nor did Schumpeter believe that the change from capitalism to socialism will require revolution. On the contrary, by the time the change occurs, there will be so few defenders of capitalism left that almost no one will object, and perhaps no one will notice. The simple substitution of state for private bureaucracy will leave worker and manager in their old jobs and give them their old satisfactions.

The secular stagnationist hypothesis, as most fervently argued by Alvin Hansen, became popular in this country in the late thirties and enjoyed something of a revival after World War II, rather briefly. Like Schumpeter, members of this school argued that the nature of capitalism had altered; but to them the principal alterations were in the decline of investment opportunities. The three major outlets for investment of the past had been rising population, expanding western settlement and technical innovation. Now, they argued, the birth rate is falling, the frontier is closed, and technical change, the system's last pillar, is uncertain and spasmodic.

In a way, the secular stagnationists are more cheerful about capitalism than was Schumpeter. Through state intervention, they plan to preserve capitalism's main features—private property and production for private profit. The secular stagnationist doctrine has been somewhat discredited by the Census of 1950 and the samplings since then which reported an enormous *increase* in birth rates, a true baby boom. Moreover, the post-World War II years have witnessed a tremendous spate of technical innovation and an enormous investment boom. As a result, most stagnationists are lying low, reflecting that the reversal in the long downward trend in birth rates is only temporary and that the cluster of innovation may also prove a last gasp. Incontestably, events have passed them by, for the time being, at any rate.

Have events also disproved Schumpeter's forecasts? The case is admittedly highly speculative, and we can hope that some fourth version of capitalism's future, neither Schumpeter's, nor Marx's, nor Hansen's, will prove more accurate. Much in the current performance of the American economy gives grounds for such a hope. ■

NEXT MONTH: Better statistics give today's economists a more rounded picture of "economic man" and force them to revise some old assumptions



READING REPORT

United States Shipping Policy. Wytze Gorter. 230 pp. New York: Harper & Brothers, for the Council on Foreign Relations. \$5.00.

•The failure of American ship operation and shipbuilding to keep pace with the economy as a whole, presents a knotty problem in which post-war economic, military and political questions cross and recross each other. The merit of this volume lies in its orderly organization of the facts pertinent to these questions and its clarity in evaluating them. Prof. Gorter is openly critical of United States maritime policies. He also makes suggestions for policy changes designed to reorganize our shipping industry on a sounder basis.

* * *

What the Tariff Means to American Industries. Percy W. Bidwell. 304 pp. New York: Harper & Brothers, for the Council on Foreign Relations. \$5.00.

•“The task of this book,” in the words of Dr. Bidwell, “was to discover what the tariff means to eight American industries,” viz: those producing hand-fashioned glassware, household china, bicycles, watches, woolens and worsteds, iron and steel, synthetic organic chemicals and electrical products. Being such a specialized study, it makes no attempt to settle the ancient question

of free trade vs. protection. Even so, the case histories presented provide valuable data for legislators and scholars concerned with the over-all tariff problem.

* * *

Policies to Combat Depression. A Report of the National Bureau of Economic Research. 417 pp. Princeton, N. J.: Princeton University Press. \$8.50.

•During any period of economic stress numerous would-be saviors arise with pat and sure-fire programs for relieving the situation. Responsible economists, however, take a more sober approach to the problem of depression. This volume, for example, emphasizes the fact that there are “many possible kinds of depressions.” In addition, formidable difficulties lie in the way of anticipating and properly identifying a potential depression, not to speak of coping with it successfully. These difficulties, as well as other aspects of the problem of depression, were surveyed at two conferences held in Princeton, N. J. under the sponsorship of the Universities-National Bureau Committee for Economic Research. In this report of the conferences, 14 economists contribute papers exploring anti-depression theories and policies. Advanced students of the subject will find here considerable grist for the mill.

An Economic Survey of Communist China. Yuan-li Wu. 566 pp. New York: Bookman Associates. \$12.50.

•An ancient Chinese saying advises: "If you want to know the road ahead, ask a man who has traveled it." The mainland Chinese of today—thanks to their Communist dictators—are ignoring this advice by attempting to travel on a quick road from a low-income agricultural society to a prosperous Western type of industrial economy. They are following the ideology of Russia rather than the experience of America. Dr. Yuan-li Wu casts new light on the results of this would-be shortcut to material abundance. His survey avoids controversial issues, but he does not hesitate to raise questions pertinent to evaluating the Communist system.

* * *

Diplomacy In A Democracy. Henry M. Wriston. 115 pp. New York: Harper & Brothers. \$2.50.

•Democracies are often chided for their alleged ineptitude in international diplomacy. How valid is such criticism? This brief but enlightening volume goes a long way toward providing an answer—one which gives comfort to democracy's proponents. Dr. Wriston reviews the development of our diplomatic and foreign service corps and outlines its present problems. He argues that since the two major powers are perhaps equal in military strength, "the question of war or peace must rest with diplomacy." And this is also a reason why all concerned with and about international problems should sharpen their understanding of the diplomatic situation by reading his book.

The Practice of Unionism. Jack Barbash. 465 pp. New York: Harper & Brothers. \$5.00.

•It is refreshing, indeed, to read a book on the union movement which is free of a chip on the shoulder, either pro or con. This is such a book. Mr. Barbash does an exceptionally good job of outlining the present status and recent development of unionism in the United States. He covers every important aspect of the subject. Though a union "insider," he does not hesitate to discuss what he calls "union pathology," i.e., racketeering and Communist infiltration. The book's sober tone and its wide range of subject matter make it a valuable guide on the role played by today's unions in our social and economic scheme of things.

* * *

The Business of Crime. Robert Rice. 268 pp. New York: Farrar, Straus & Cudahy. \$3.75.

•In his introductory remarks, the author announces his conviction "that all too often in our society the moral difference between a businessman and criminal is imperceptible." Perhaps Mr. Rice has some substantial evidence for his conviction, but he does not reveal it in this book. Instead, we find a well-written, journalistic *tour de force* covering the criminal escapades of arsonists, counterfeiters, narcotics smugglers and similar worthies who, the author says, used the "accustomed tools and techniques of business." That these are hardly typical examples of business activities, or even of the criminal lapses sometimes committed in the course of legitimate business, seems to escape the author. Why, then, attempt to equate or relate them with productive enterprise? ■



Challenge Quiz

HOW WELL can you do with this true-false quiz? Test your ability to increase your knowledge through reading. Ten correct answers is Excellent; 9 Good; 8, Average. If you do the quiz *before* reading the articles, 6 correct answers is Good. Answers on page 37.

- | | |
|---|---|
| <p>(1) Tax rates above 50 per cent on personal income contribute relatively little to the Treasury's total revenue.
True ☐ False ☐</p> <p>(2) The property tax provides the most equitable source of local governmental revenue.
True ☐ False ☐</p> <p>(3) The tax system, operating as an automatic stabilizer in the national economy, can prevent either inflation or deflation.
True ☐ False ☐</p> <p>(4) Under the percentage depletion tax allowance, a taxpayer can continue to deduct the percentage even after the entire cost of the property has been deducted.
True ☐ False ☐</p> <p>(5) The proposed tax on energy in France is intended to reduce income taxes.
True ☐ False ☐</p> <p>(6) Tax money withheld for social security is available for the ordinary operating budget of the government.
True ☐ False ☐</p> | <p>(7) The major source of state revenues is consumption taxes.
True ☐ False ☐</p> <p>(8) Due to tax exemptions and loophole provisions, only about one-third of the total amount of U.S. personal income is actually subject to the federal individual income tax.
True ☐ False ☐</p> <p>(9) Excise taxes on alcoholic beverages and tobacco discourage their consumption and therefore produce comparatively small revenues.
True ☐ False ☐</p> <p>(10) If Americans were told precisely what taxes buy, they would mind paying them less.
True ☐ False ☐</p> <p>(11) U.S. tax policy increases the real incomes of those with less than 1,000 dollars a year by almost 75 per cent.
True ☐ False ☐</p> <p>(12) The Social Security Act now covers more than 90 per cent of the labor force.
True ☐ False ☐</p> |
|---|---|



Dept. of Better Mousetraps

Personal Business: a compartmentalized leather attaché case covered with scuff-resistant vinyl . . . a cultured pearl, still in its oyster and vacuum-packed in a can . . . a gold-plated safety razor that hones a double-edged blade automatically . . . soap, in a tube for tucking into a pocket or overnight bag, which lathers instantly when hands are placed under water . . . and a nail-polish "valet" which holds the bottle securely while one applies the polish.

* * *

From the World of Industry: an electric wrist-watch of conventional size. Its battery lasts 18 months and can be replaced by a jeweler for about \$1.75 . . . a paint that keeps water out but allows inside moisture to escape . . . an electronic device that enables blind people to locate light sources by converting the light into sound . . . and a sun-powered portable radio—at night it works on batteries.

* * *

Junior Department: a Tom Thumb portable typewriter with standard keyboard in a metal case—perfect for school work . . . a modeling compound in brilliant colors that is non-sticky, non-staining, requires no tools, moistening, kneading, can be hardened by the air or slow oven, and then sanded, carved and decorated . . . for the science-minded teen-ager, a kit

with manual from which to construct logic, arithmetical, code and other simple computers . . . and a sturdy duck strap that fits over your shoulder and under the baby on your hip, leaving, your hands free.

* * *

About the House: elastic bandage of nylon which maintains its compression strength regardless of moisture, body heat or muscular motion . . . a cloth to rub over windows, the bathroom mirror or car windshield to prevent steam or fog from forming . . . an expandable hamper that holds over four bushels of laundry, to attach to the end of a laundry chute, made of heavy-duty elastic . . . and, for all kinds of repairs, plastic steel which hardens in two hours. Part plastic and part steel, it adheres to aluminum, brass, iron, wood, glass, concrete, and other surfaces.

* * *

Kitchen Kuties: a rust-proof steel gadget with five interchangeable blades that slice, chop, shred and grate . . . a frankfurter cooker—press the lever and it revolves like a spit over flames . . . and an electric can opener that opens cans of any size or shape, even damaged ones, has a removable blade and a magnet that holds the lid.

* * *

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